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## **SECTION II - REQUIREMENTS**

### **A. ACCOUNTING PRINCIPLES AND BASIS OF ACCOUNTING**

#### **A.01 ACCOUNTING PRINCIPLES**

Accounting may be defined as the analyzing, recording, summarizing and interpreting of financial transactions of an economic enterprise. Accounting for school districts comprises these same activities under the restrictions imposed by federal, state, and local authorities. When financial transactions presented in accordance with generally accepted accounting principles differ from those based on legal requirements, supplemental schedules should be prepared to disclose legal compliance.

It is not the function of this manual to precisely define the accounting methods that should be used by all school districts since districts vary widely in size and complexity. In choosing accounting methods to be followed, it should be emphasized that a major purpose of school district accounting is to produce financial statements that will enable policy makers, administrators, managers, and others to understand the financial position and operations of the district. Any improvements and refinements in the system that will lead to more accurate, timely, and understandable financial statements should be considered. It is necessary to balance the benefits of an improved system with the related costs for implementation. As a minimum, an adequate school district accounting system should meet each of the criteria listed below as stated in *Principles of Public Accounting* published by the U.S. Department of Health, Education, and Welfare.

A school district financial record system should be adequate to provide financial and related operational information for all interested parties; the school board; the administration; the public; auditors; local, state, and federal authorities; and school employees. The adequacy of the accounting systems depends on whether both current and historical information is available for decision-making purposes.

The accounting system should be designed to demand accuracy and a reasonable degree of internal control. If so designed, it will automatically assist those who are performing the daily work on the records as well as those who supervise them.

A school district accounting system should be consistent with generally accepted governmental accounting principles. Valid comparisons of monthly or yearly operations in different time periods can be made only if the items are treated in a consistent manner. Changes and improvements in the accounting system may prove necessary and these should be made at logical times in the accounting period.

School district financial accounting systems should be uniform to permit maximum usefulness. They should allow for financial, operational, or performance comparisons with other school districts on local as well as state and national levels. Uniformity will insure that the items being compared are similar items, and standard terminology and definitions should be used.

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### **A. ACCOUNTING PRINCIPLES AND BASIS OF ACCOUNTING**

#### **A.02 BASIS OF ACCOUNTING**

A school district's accounting basis determines when accounting transactions and economic events are reflected in its financial statements. NCGA-1 (Governmental Accounting and Financial Reporting Principles) states that basis of accounting refers to "when revenues, expenditures, expenses and transfers-and related assets and liabilities – are recognized in the accounts and reported in the financial statements." The modified accrual basis is the accepted method of governmental fund accounting for the economic resources of a school district. This would include the General, Special Revenue, Capital Project, Debt Service, and Expendable Trust funds. Under this method:

**Revenues** are recognized when they meet both measurable and available criteria. "Available" means the revenue is collected either during the year, or soon enough after the end of the year that it can be used to pay liabilities of the current year. See Section II. E.02 for additional guidance related to the accrual of revenues.

**Deferred Revenues** are recorded when potential revenue does not meet both the measurable and available criteria for recognition in the current period. In most cases, resources are considered available if they are collected during the fiscal year or will be collected within 60 days of fiscal year end. If the district receives the funds before it has legal claim to them, a liability should be established. For example, a district receives adult education funds under the State School Aid Act, MCL 388.1707 during the fiscal year, but does not spend them during the year for allowable adult education programs. A liability should be established in the amount of adult education funds received but not expended for adult education. In subsequent periods, when both revenue criteria are met, the liability may be extinguished and corresponding revenue recognized.

**Expenditures** are recognized when the related fund liability is incurred, except for principal and interest on long term debt which are recorded when due. As an example, expenditures for payroll should be recorded in the period in which the services to receive the compensation were completed.

**Encumbrances** or commitments related to uncompleted contracts for goods or services are recorded for budgetary control purposes. Encumbrances outstanding at year end represent the estimated amount of the expenditures that will be incurred when contracts in process at year end are completed. Encumbrances outstanding at year end do not constitute expenditures or liabilities. However, it is appropriate to establish a year end reserve for encumbrances which set aside a portion of fund balance.

**Inventories** may be accounted for using either the purchases or consumption method. Under the purchases method, inventories are treated as expenditures when purchased regardless of when they are actually consumed. Under the consumption method, inventories are treated as expenditures when used. Districts should refer to the *Michigan School Audit Manual* for further information related to accounting for inventories of School Food Commodities and Bonus Commodities.

## **SECTION II - REQUIREMENTS**

### **A. ACCOUNTING PRINCIPLES AND BASIS OF ACCOUNTING**

**Fund Modifications-** Transfers of financial resources among funds should be recognized in all funds affected in the period in which the inter fund receivable(s) and payable(s) arise.

#### **Basis of Accounting for Proprietary and Non-Expendable Trust funds**

Districts should utilize the full accrual basis of accounting when operating Proprietary funds (Internal Service and Enterprise) and non-expendable Trust funds. Under this method, revenues are accrued when earned and expenditures are recognized when incurred for goods and services. Fixed Assets and long term debt incurred for proprietary fund purposes are to be recorded in the proprietary fund accounts with periodic depreciation charged against fund revenues. We encourage districts to consult with their auditors before establishing proprietary funds because of the accounting differences they present.

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**A. ACCOUNTING PRINCIPLES AND BASIS OF ACCOUNTING**

## **SECTION II - REQUIREMENTS**

### **B. FUND ACCOUNTING**

#### **B.01 DESCRIPTION**

A school district accounting system should be organized and operated on a fund basis. A fund is a fiscal and accounting entity with a self-balancing set of accounts. Legal reporting requirements and the varied nature of school district's operations make it necessary for the school district to account for its activities through the use of separate funds. Each fund will account for designated assets, liabilities, fund equity, revenues, and expenditures based upon the purpose of the fund.

District-wide reporting should include information related to accounting and control over long-term debt and capital assets.

## **SECTION II - REQUIREMENTS**

### **B. FUND ACCOUNTING**

#### **B.02 TYPES OF FUNDS**

School districts are allowed to maintain the following seven types of funds. The first four funds are used principally to account for the ongoing activities of the school district financed with general school district revenues in the form of taxes, state aid, grants and other entitlements. They are also used to record the acquisition of capital assets.

##### **a) GENERAL FUND**

All transactions related to the operation of the school district, except those transactions required by law to be entered in other funds, are recorded in the General Fund.

Local taxes and all other operating revenues or assets received or due from local, state and federal sources are recorded in this fund. Expenditures financed by these revenues are also recorded in the General Fund.

##### **b) SPECIAL REVENUE FUNDS**

Special Revenue Funds are used to account for activities where there is a need to determine the results of operations, such as food service, bookstore, community service, inter-scholastic athletic funds, and private purpose trust funds.

Intermediate School Districts and Local School Districts that operate a Center Program as specified in Section 6 of the State School Aid Act may also keep a Special Education Fund. Intermediate School Districts may also maintain Vocational Education and Cooperative Education funds.

Many districts may have grants and other programs that they may consider special revenue funds. However, if those programs or grants are used for the primary purpose of educating the district's K-12 pupils they are to be reported in the General Fund on the Comprehensive Annual Financial Report reported to the state. The district may maintain them internally in separate funds, but for state reporting they should be combined to the General Fund. Districts should be aware that keeping separate funds internally may promote confusion with financial data users as local and state financial reports may differ.

##### **c) DEBT SERVICE FUNDS**

The receipt of funds for the payment of interest, principal, and other expenditures on long-term bonded debt are recorded in the Debt Service Fund. Primary sources of revenue for this fund are debt retirement tax levies and earned interest.

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### **B. FUND ACCOUNTING**

#### **d) CAPITAL PROJECTS FUNDS**

The purpose of the Capital Project Fund is to account for receipt and disbursement of monies used for the acquisition of capital assets, including land, buildings, and equipment. Principal sources of revenues are from the sale of bonds, tax levies, and earned interest. Unexpended resources no longer needed on projects for which the bonds were originally approved generally must be transferred to the Debt Service Fund. Legal counsel should be sought for questions related to the appropriate use of funds levied through a voter approved millage.

#### **e) TRUST FUNDS**

Trust Funds are used for assets under the administrative control of the school district functioning in a trustee capacity. The school district typically exercises discretionary authority over the investment of the trust fund assets, and as trustee, must take responsibility for the expenditure of assets for their intended purpose. Examples include situations where a school district typically agrees to function in a trustee capacity for endowments, gifts and bequests and, under certain circumstances, foundations.

#### **f) AGENCY FUNDS**

Agency Funds are custodial in nature. They are used to report assets received and disbursed on behalf of student groups and other school related groups. The school district acts as the receiving and paying agent for these groups.

Agency funds are typically limited to student activity funds and other school organizations such as parent booster clubs. Liability transactions of a specific fund should be recorded in the same fund rather than using separate agency funds. For example, payroll withholdings of general fund employees should be recorded in the general fund. Likewise, flow through funds from other governmental agencies should normally be recorded in the general fund (or other specific governmental funds) rather than in an agency fund.

Agency funds do not generate revenue and expenditure transactions since they do not conduct operations. Funds held in an agency capacity are liabilities. Consequently, agency funds report assets and liabilities; they do not report equity, but rather recognize a liability "due to student and other school groups." Since agency funds do not conduct operations, they do not formally report revenues and expenditures. However, in order to report the total activity of agency funds, the Michigan Department of Education requires a recap of receipts and disbursements of agency funds be reported each year on the Comprehensive Annual Financial Report (FID).

## **SECTION II - REQUIREMENTS**

### **B. FUND ACCOUNTING**

#### **g) PROPRIETARY FUNDS**

Proprietary Funds should be used in situations where the flow of economic resources is required. As mentioned earlier, the accounting and reporting are on full accrual basis. Two examples of proprietary funds that districts may operate are Enterprise and Internal Service funds.

Enterprise funds – This fund type may be used to report an activity for which a fee is charged to external users for goods and services. We encourage districts to check with Generally Accepted Accounting and Reporting for governmental units and their local school district auditor before establishing an enterprise fund as this type of fund utilizes different accounting and reporting standards.

Internal Service funds- An Internal Service Fund may be used to account for activities that involve the governmental entity providing goods or services to other funds or activities of the school district. Some examples may include a district wide print shop operation or a self-funded insurance program. We encourage districts to check with Generally Accepted Accounting and Reporting for governmental units and their local school district auditor before establishing an internal fund as this type of fund utilizes different accounting and reporting standards.

## **SECTION II - REQUIREMENTS**

### **B. FUND ACCOUNTING**

#### **B.03 DISTRICT WIDE REPORTING OF CAPITAL ASSETS AND LONG TERM DEBT**

Districts must maintain information on Long Term Debt and Capital Assets for reporting under GASB-34 standards. The *Michigan School Accounting Manual* provides two district-wide reporting account groups to keep track of the information.

##### **a) LONG-TERM DEBT ACCOUNTS**

This account group is used to account for the unmatured principal of bonds, notes and other forms of non-current liabilities or long-term general obligation indebtedness that is not a specific liability of any other fund.

##### **b) CAPITAL ASSET ACCOUNTS**

This account group is used to account for capital assets (land, buildings, vehicles and equipment) owned by the school district. Capital assets do not represent financial resources available for expenditure but are items for which financial resources have been used. The cost of capital assets acquired are charged as expenditures in another governmental fund as incurred while accountability for those assets should be maintained in the Capital Asset Account Group throughout the life of the asset.

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**B. FUND ACCOUNTING**

## **SECTION II - REQUIREMENTS**

### **C. STATE REQUIREMENTS**

#### **C.01 GENERAL**

##### **a) INTRODUCTION**

The Michigan Compiled Laws contain the legal requirements for school district accounting. The Compiled Laws, together with Administrative Code Rules governing school accounting, have the force and effect of law and are legally binding on Michigan's local educational agencies. This manual, having been adopted by the State Board of Education and incorporated into Administrative Code Rules R340.851 -R340.854, is the required accounting manual for Michigan public schools.

There are additional requirements found in the Michigan Compiled Laws that are not specifically mentioned in the manual. If specific questions are raised, a thorough study of Michigan Compiled Laws and Administrative Code Rules should be made before arriving at a decision. In some cases, school authorities should obtain legal advice pertaining to a specific transaction prior to its initiation.

##### **b) SPECIFIC REQUIREMENTS**

**Accounting** - Each school district must adopt the basic accounting system as prescribed by the Michigan Department of Education and in the *Michigan Public School Accounting Manual*. Authorization is found in Revised School Code (MCL 380.1281(1c) and MCL 380.622(1)) and Administrative Rule (R340.852). A system of modified accrual accounting for government funds is required. The fiscal and accounting year begins with the first day of July in each year. (MCL 380.1133)

**Auditing** - Accounting documents and records must be audited annually by a certified public accountant. A copy of the audited financial statements must be transmitted to the Michigan Department of Education. (MCL 388.1618)

**Budgeting** -Each intermediate school district (ISD) operating under the 15 mill tax limitation must submit its budget and statements to the County Allocation Board on or before the third Monday in April of each year. P.A 621, The Uniform Budgeting and Accounting Act of 1978, outlines budget requirements for local units of government. **Michigan public schools are required to post a copy of their board adopted budget on a district website within 30 days of adoption (MCL 388.1618). See Section IV of this manual for more information related to budgets.**

**Reporting** -The treasurer of the district or other appointed fiscal agent must keep records of receipts and disbursements and identify the sources from which the same have been paid. A report must be presented to the board after the close of each school year. Every board shall make an annual report to the Michigan Department of Education. (MCL 380.1618)

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**C.02 TAX LIMITATION AMENDMENT (HEADLEE)**

**a) DESCRIPTION OF THE ISSUE**

The Headlee Amendment (P.A. 35 of 1979) added 10 sections to the Michigan Constitution and amended another. It imposes tax limitations on the state, county, municipal, school district and related local governmental units. There are six basic restrictions or provisions:

- The Amendment limits growth in state revenue to the growth in personal income for the State of Michigan.
- The Amendment prohibits the state from mandating activities of local governments without reimbursing these local governments for the increased costs.
- The Amendment requires a roll back in local millage rates if the local tax base (taxable value) increases more than inflation (Headlee Rollback).
- The Amendment requires voter approval for bonds pledging the full faith and credit of the local government.
- The Amendment prohibits the imposition of any local tax not previously authorized without voter approval.
- Tax limitations (rollback) do not apply to debt service millage rates.

**b) FACTORS NEEDED TO DETERMINE HEADLEE ROLLBACK**

1) Inflation Rate: Computed by the Michigan Department of Treasury and published by the State Tax Commission in January of each year. The data are disseminated to local assessors and county equalization directors.

2) Current Year taxable value (TV) as certified by County Treasurer by second Monday in June.

- Current year additions in TV

- Current year losses in TV

3) Prior Year: Taxable value (TV).

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**c) CURRENT YEAR MILLAGE REDUCTION FRACTION**

The "Current Year Millage Reduction Fraction" "MRF," is a very important concept and is calculated as follows:

$\frac{(\text{Prior Year Taxable Value} - \text{Current Year Taxable Value losses times the inflation rate (2.xxx)} / (\text{Current Year Taxable Value} - \text{Current Year Taxable Value Additions}))}{\text{Current Year Taxable Value}}$	= Millage Reduction Fraction (MRF)
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If MRF is less than 1.0--- the TV has increased faster than the rate of inflation and rollback is required.

If MRF is 1.0 or greater--- the TV has increased as fast or less than the rate of inflation.

A Rollback is Required Only If The Compounded MRF Is Less Than 1.

Starting with taxes levied in 1994, the "Headlee" rollback permanently reduces the maximum, rate or rates authorized by law or charter. A compound millage rate is no longer calculated.

Beginning in 1996, one rollback fraction is calculated and applied to local school district millage levied on all property: i.e. sinking fund millage, library millage, community college millage, enhancement millage (1996 only), the number of operating mills authorized to be levied by hold-harmless districts on all property, after combining the "basic" and supplemental millages.

A separate rollback fraction is calculated and applied to local school district millage levied only on property that is not homestead or qualified agricultural property: "basic" mills...18 or the 1993 rate whichever is less, reduced by the number of supplemental mills authorized by the school code to be levied by hold-harmless districts.

For most districts, only the rollback fraction on "nonhomestead" property is applied. For 1997, this fraction is calculated using the 1996 and 1997 taxable value of property that in 1997 is not homestead or qualified agricultural property. (If property is "nonhomestead" in 1997, its 1996 and 1997 values are used in the calculation, even if the property was homestead property in 1996.)

See State Tax Commission Bulletin No. 10 of 1997 for further discussion of Millage Rollbacks. For the State Tax Commission recommended method for calculating millage rollbacks for districts levying supplemental ("hold-harmless") mills, see their memo of June 9, 1997.

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**d) AUTHORIZED MILLAGE RATE**

1) If MRF is Less than 1.0; MRF multiplied by Prior Year Millage Rate is Permanently Reduced by MCL 211.34d	= Current Year Authorized Millage Rate
2) If MRF is 1.0 (MRF cannot exceed 1.0); Prior Year Millage Rate is Permanently Reduced by MCL 211.34d	= Current Year Authorized Millage Rate
3) Current Year Authorized Millage Rate (or "Current Year Millage Rate Permanently Reduced by MCL 211.34d")	= Total Millage Rate Allowed to be Levied under Headlee Amended (unless a specific vote of taxpayers allows a greater amount.)

**e) EXCEPTIONS**

- 1) Additional voted millage approved after 5/31 of each year. Reduced, if necessary, beginning with subsequent year levy.
- 2) Taxpayers can approve the levy of a tax rate in excess of limit set by rollback by approving the levy of a specific number of mills in excess of the limit.

**f) ADJUSTMENTS**

Adjustments to the authorized millage rate in the subsequent year will be required if excess tax revenue in the current year resulted from:

- Error in prior levy
- Taxable value is changed as a result of an equalization appeal

Adjustments to the authorized millage rate in the subsequent year may be made if the above resulted in a shortage of tax revenue in the current year. Anytime there is a taxable value change, its possible impact on state membership aid should be considered.

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**C.03 TRUTH IN TAXATION ACT**

**a) EXPLANATION OF ACT (Public Act No. 5, P.A. of 1982)**

If the taxable value of existing property subject to ad valorem taxes within a school district increases from one year to the next, the millage rate that can be levied will AUTOMATICALLY decrease unless the school board acts to approve the levy of an “additional millage rate.” This Act specifically excludes debt retirement millage and building and site millage.

If a school district complies with Section 16 of the Uniform Budgeting and Accounting Act and MCL 141.412, it is not required to comply with the truth-in-taxation requirements.

The new requirement of Section 16 of the Uniform Budgeting and Accounting Act is that the Appropriations Act must set forth the millage rate to be levied and the purposes for that millage. MCL 141.412 requires the published notice of the budget hearing to include the following statement printed in 11-point boldfaced type: “The property tax millage rate proposed to be levied to support the proposed budget will be a subject of this hearing.”

**b) LIMITATION ON LEVY**

A school board may not levy an operating millage for an ensuing fiscal year if that millage levy will generate more revenue than the sum of:

- 1) An amount equal to the taxes levied for operating purposes for the concluding fiscal year on existing property; plus
- 2) An amount equal to the taxes levied at the “base tax rate” on additions to taxable property for the ensuing year.

“Base Tax Rate” BTR = ((Prior Year Taxable Value Minus Losses) <b>divided</b> by (Current Year Taxable Value- Additions)) <b>Multiplied</b> by Prior Year Levied Millage Rate.
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c) **EXAMPLE**

An example of how Truth in Taxation would affect a school district can be shown as follows:

1996-97 TV = \$132,000,000 (assumes no losses)
1996-97 Levied Millage Rate = 18 Mills
1997-98 TV (less additions) = \$150,000,000
$BTR = \$132,000,000 / \$150,000,000 = .8800 \times .018 = .01584 = 15.84 \text{ mills}$

In this example, the millage levy limitation would be 15.84 mills unless the school board approved a higher levy in accordance with Truth in Taxation.

d) **BOARD ACTION REQUIRED**

- 1) Adopt a resolution proposing an additional millage rate
- 2) Publish notice of a public hearing - six days prior to hearing
- 3) Hold a public hearing on proposed increase
- 4) Adopt a resolution approving the levy of an additional millage rate, at least seven days after hearing

Specific details are spelled out in the Act for approving an additional millage. The board must, by resolution, announce its intent to levy the millage that it wishes to restore prior to the public hearing. The board action to officially approve the levy of this millage rate cannot be taken until seven days after the public hearing.

e) **ADDITIONAL REQUIREMENTS**

School board members and administrators should note the following requirements applicable to the notice and public hearings provisions of the Act:

- 1) Notice - Notice of a public hearing must be published in a newspaper of general circulation and shall not be placed in that portion of the newspaper reserved for legal notices and classified advertisements. This notice shall be published not less than six days before the public hearing. The newspaper notice must be eight vertical column inches by four horizontal inches. The notice must be in not less than 12-point type and must be preceded by a headline in not less than a 18-point type. The headline shall read: "Notice of a Public Hearing on Increasing Property Taxes." The notice must specify the time, date and place of the public hearing. Additionally, the notice must include a statement indicating the proposed additional millage rate and the percentage by which this proposed millage rate would increase revenues for operating purposes. Further, the notice must also provide a statement that the school board has complete authority to

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establish the number of mills to be levied from within its authorized millage rate. Finally, the school board may include whatever other pertinent information it wishes.

2) Public Hearing - A public hearing must be held to discuss the levy of additional millage as proposed in the notice. The hearing must be held in compliance with the Open Meetings Act and may be held jointly with the school district's annual public hearing on the proposed budget. If both public hearings are held jointly, the notice required by Public Act 5 may be published jointly with the notice of the budget hearing.

#### **f) HOW MANY MILLS CAN THE BOARD RESTORE?**

1) Mills can be restored up to the less of:

- Headlee limitation
- Total mills voted by the electorate

2) Mills can be restored above Headlee limitation to the total mills voted by the electorate if submitted to the voters.

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### **C. STATE REQUIREMENTS**

#### **C.04 50 MILL LIMITATION**

##### **a) BACKGROUND**

The Constitution of the State of Michigan of 1963, limits the aggregate amount of millage that may be levied to 50 mills. The passages that follow explain how this limitation affects operations in Michigan school districts.

The Constitution states in Article IX, Section 6:

*...Except as otherwise provided in this constitution, the total amount of general ad valorem taxes imposed upon real and tangible personal property for all purposes in any one year shall not exceed 15 mills on each dollar of the assessed valuation of property as finally equalized. Under procedures provided by law, which shall guarantee the right of initiative, separate tax limitations for any county and for the townships and for school districts therein, the aggregate of which shall not exceed 18 mills on each dollar of such valuation, may be adopted and thereafter altered by the vote of a majority of the qualified electors of such county voting thereon, in lieu of the limitation therein before established. These limitations may be increased to an aggregate of not to exceed 50 mills on each dollar of valuation, for a period of not to exceed 20 years at any one time, if approved by a majority of the electors, qualified under Section 6 of Article II of this constitution, voting on the question.*

##### **b) NONAPPLICATION OF LIMITATION**

The foregoing limitations shall not apply to taxes imposed for the payment of principal and interest on bonds or other evidences of indebtedness or for the payment of assessments or contract obligations in anticipation of which bonds are issued, which taxes may be imposed without limitation as to the rate or amount; or to taxes imposed for any other purpose by any city/village, charter county, charter township, charter authority or any other authority, the tax limitations of which are provided by charter or by general law.

##### **c) COURT RULING**

The Michigan Court of Appeals has ruled the following:

- 1) Any challenge to the 50 mill limitation must originate with the Michigan Tax Tribunal.
- 2) That an individual taxpayer could bring action because their taxes would be increased or decreased a specific amount depending upon the outcome of the litigation.
- 3) That the Headlee Amendment left the former 15 mill, 18 mill, and 50 mill limitation intact and merely added additional restrictions to charter millage.

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**d) APPLICATION**

The following chart shows the application of the Limitation:

Taxing Unit	Limitation Applies	Limitation Does Not Apply
Allocated Millage		
Extra Voted Millage:	X	
School Operational		
School Specially Designated	X	
School Building and Site	X	
Township	X	
County	X	
Debt Retirement Millage	X	
Chartered County		X
Chartered City Millage		X
Chartered Township Millage		X
Intermediate School District:		X
Special Education		
Vocational Education		X
(Chartered)		X
Community College (Chartered)		X
Home Rule Villages (Chartered)		X
General Law Village		X
Special Assessments		X
i.e., fire and police		X
Authorities Created by law		
i.e., Peoples Community Hospital, Huron- Metropolitan Authority	Clinton	X

**e) LEGAL QUESTIONS**

The issues involved and whether millage are subject to the 50 mill limitation provided in the first paragraph of Section 5, Article IX, of the Constitution or are subject to the non-application of the limitation are legal questions that have not been fully defined. School districts should consult legal counsel, if questions arise.

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## **SECTION II - REQUIREMENTS**

### **D. FEDERAL REQUIREMENTS**

This section summarizes basic principles for accounting for funds in a federal program regardless of the purpose for which the funds are provided. Each statute authorizing a federal, state, or cooperative state federal program in education provides that the grantee is responsible for administering the program.

Most decisions on specific items for which grant funds are expended are made at the local level. However, basic decisions on use of equipment and services acquired with grant funds must be in compliance with federal and/or state requirements.

#### **D.01 GENERAL**

##### **a) ACCOUNTING RECORDS**

Financial administration of grant funds is reflected in the school district's accounting records. During a fiscal year, it is not uncommon for an agency to administer grants from more than one program and/or to operate two or more projects within the same program. The financial transactions of an approved project should be distinguished in the accounting records from other approved projects and identified with the federal and/or state program under which it is funded. Project expenditures should also be recorded within the function and the object classifications provided in this manual.

##### **b) SUPPORTING DOCUMENTATION**

It is essential that every entry in the accounting records refer to the documentation that supports the entry and that the documentation be filed in such a way that it can be readily located. Documentation for purchases should include copies of the purchase order and/or purchase requisition, contracts, invoices, receiving reports, and canceled checks or warrants. Inventory records should be maintained for equipment items purchased.

Payroll records should provide sufficient documentation for employees engaged full time in a single activity. Official personnel actions, job sheets, and/or official assignment schedules should support employees' time when assignment is to two or more activities. These records should be substantiated periodically by after the fact reports, supervisors' reports, time studies, or other formal evidence showing that the employees actually spent the prorated portion of their time on the assignments indicated.

Certain programs require that the grantee contribute to the program. The contribution may be goods and/or services purchased from general operating funds and not necessarily recorded as program expenditures. However, the contribution must be documented as having supported the program. Such documentation may be maintained on a memoranda basis provided it is retained in accordance with applicable statute(s).

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### **D. FEDERAL REQUIREMENTS**

Each school district that operates a federal program should keep in the business office, a copy of the Code of Federal Regulations (CFR 34, parts 1 to 700) in which the regulations for federal educational programs are published. References of specific interest to school business officials are:

- Part 76 – State Administered Programs
- Part 84-298 - Innovative Education Program Strategies ESEA of 65 Title VI to assist State and Local Educational Agencies (LEA) in the reform of elementary and secondary education.
- Part 84-010 - Financial Assistance to Local Education Agencies to LEAs and Schools to improve the teaching and learning of children failing or most at/risk of failing (Title I).

Copies of the three books that comprise CFR 34, part 1 to 700 can be obtained from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402 (telephone 202-783-3238).

**SECTION II - REQUIREMENTS**  
**D. FEDERAL REQUIREMENTS**

**D.02 OVERVIEW - SINGLE AUDIT REQUIREMENTS FOR MICHIGAN SCHOOL DISTRICTS**

**a) INTRODUCTION**

The Single Audit Act of 1984 (P.L. 98-502) was amended in 1996 (P.L. 104-156). The revised *OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations* establishes minimum audit requirements for States, Local Governments (local and intermediate school districts, including public school academies) and non-profit organizations that receive federal financial assistance and defines responsibilities for implementing and monitoring these federal requirements. In order to assist the school districts and independent auditors in meeting the Single Audit Act and OMB Circular A-133 requirements, the Michigan Department of Education (MDE) has prepared a separate document called *Michigan School Auditing Manual*. This section of the *Michigan Public School Accounting Manual* highlights only the major topics related to the single audit. For further information, please refer to the *Michigan School Auditing Manual*.

As the primary recipient of federal funds, the MDE, Office of Audits, is responsible for reviewing audits and resolving the audit deficiencies and findings in a timely manner. When audit deficiencies are discovered, school districts and/or independent auditors are contacted to resolve the deficiencies and correct the reporting. As required by the *Government Auditing Standards* and the *Michigan School Auditing Manual*, school district's corrective actions taken or planned must be included with the audit report. If the corrective actions are not included in the audit, the Office of Audits will contact the school district for management's response to the audit findings. If there are questioned costs on funds passed-through the MDE, the funds should be returned to the MDE as soon as the questioned costs are determined.

**b) AUTHORITATIVE LITERATURE**

Refer to the *Michigan School Auditing Manual*.

**c) THRESHOLDS**

Under OMB Circular A-133, the current audit threshold is \$500,000 of federal expenditures. The MDE requires districts, including public school academies, that expend \$500,000 or more a year of federal financial assistance to procure an audit made in accordance with Generally Accepted Auditing Standards (GAAS), Government Auditing Standards (GAS), the OMB Circular A-133, the Single Audit Act of 1984, as amended in 1996 and the *Michigan School Auditing Manual*.

School districts, including public school academies, that expend less than \$500,000 a year of federal assistance, are required by the MDE to procure an audit made in accordance with Generally Accepted Auditing Standards (GAAS) and Government Auditing Standards (GAS).

## **SECTION II - REQUIREMENTS**

### **D. FEDERAL REQUIREMENTS**

#### **d) FEDERAL ASSISTANCE**

The two broad categories of federal assistance are financial and non-financial, (for example, training; USDA Entitlement and Bonus Commodities; and advisory services). School districts shall be considered to have received federal financial assistance whether such assistance is received directly (as a recipient) from a federal agency or indirectly (as a sub recipient) through a state or local government agency. In accordance with the OMB Circular A-133 (sub-section 205, *Basis for Determining Federal Awards Expended*), the determination of when an award is expended should be based on when the activity related to the award occurs.

Federal financial assistance refers to the transfer of money, property, services, etc. to a school district for carrying out a federal program in order to stimulate or accomplish a public purpose of support authorized by federal statute. The specific types of federal financial assistance provided by federal agencies are in the form of grants, contracts, cooperative agreements, loans, loan guarantees, property, interest subsidies, insurance, or direct appropriations, but not direct federal cash assistance to individuals.

#### **e) REQUIRED REPORTS**

Various reports are required at both the Financial Statements Level and the Federal Financial Assistance Level. Refer to Section A of the *Michigan School Auditing Manual* for the required reports.

#### **f) SUBRECIPIENT MONITORING**

Some Michigan school districts that receive pass-through federal grants sub grant the funds to other agencies. In accordance with the OMB Circular A-133, recipient school districts acting as fiscal agents for federal programs that provide (pass-through) federal financial assistance to sub-recipients have additional program control, financial and audit related responsibilities.

For further information on this subject, refer to Section D of the *Michigan School Auditing Manual*. Also, as required by Section B of the *Michigan School Auditing Manual*, school districts should also provide a *Schedule of Federal Financial Assistance Provided to Sub-recipients* in the audit.

#### **g) SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS**

This schedule should be prepared as required by Section B of the *Michigan School Auditing Manual*. The following matters should be considered in preparation of this schedule:

- Include all columns as required by Section B of the *Michigan School Auditing Manual*.
- For the MDE projects, the names of project, CFDA numbers, source/project numbers, approved amounts, and current year payments (which become cash receipts for the school districts) should agree with the Form R7120, Grants Section Auditors Report.
- Beginning and Ending Balances of Accrued and/or Deferred Revenue should be calculated correctly and reported for each applicable project.

**SECTION II - REQUIREMENTS**  
**D. FEDERAL REQUIREMENTS**

- Accrued Revenue represents an excess of allowable expenditures over cash received in the current period. In other words expenditures are incurred (and revenue is recognized) in the current period, however, funding will be received in a future period.
- Deferred Revenue represents payments received from federal, state, and other sources that may be used to fund future program expenditures (federal financial assistance has been received before being earned) or, if not used, must be returned to the funding sources.

**h) DISTRIBUTION OF REPORTS**

As required by Section 18(2) of the State Aid Act, Financial and the Single Audit reports are due to the MDE on November 15 at the following address:

Michigan Department of Education  
Office of Audits  
P.O. Box 30008  
Lansing, MI 48909

School districts failing to meet the deadline will not receive State School Aid payments until the reports are filed with the MDE.

For mailing instructions and addresses of other agencies which need the audit report, refer to Section C of the *Michigan School Auditing Manual*.

**SECTION II - REQUIREMENTS**  
**D. FEDERAL REQUIREMENTS**

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.01 GASB INTERPRETATION #6 – RECOGNITION AND MEASUREMENT OF CERTAIN LIABILITIES AND EXPENDITURES IN GOVERNMENT FUND FINANCIAL STATEMENTS**

Under GASB #34, liabilities are determined at two different levels: the District-wide level, and the Fund level.

##### **1) District-wide Level Liabilities**

The District-wide statements are on a full accrual basis in order to properly measure the flow of all economic resources. The District-wide Statement of Net Assets should record all obligations to third parties as soon as they are incurred, regardless of the timing of the cash flow. The accounting literature provides only a few examples of obligations that are not to be recorded as a liability:

- Commitments to purchase goods or services in the future;
- Obligations to pay future pension benefits or retiree health care benefits;
- The portion of contingent liabilities that is not probable of payment or not estimable.

##### **2) Fund Level Liabilities**

Fund level statements are on the modified accrual basis. The purpose of modified accrual accounting is to measure flows of current financial resources.

GASB Interpretation #6 clarifies the application of standards for modified accrual recognition of certain liabilities and expenditures in areas where differences have arisen, or potentially could arise, in interpretation and practice.

In the absence of an applicable accrual modification, as described in the next paragraph, governmental fund liabilities and expenditures should be accrued at the time they are incurred. Liabilities that governments normally pay in a timely manner and in full from expendable available financial resources, (for example, salaries and utilities) should be recognized when incurred, without regard to the extent to which resources are currently available to liquidate the liability.

The GASB recognizes that certain specific long-term indebtedness should be reflected at the Fund level only when it comes due for payment, rather than when it is incurred. This “accrual modification” applies to the following specific liabilities:

- Long term scheduled indebtedness (such as bond issues, capital leases, etc.)
- Compensated absences (such as sick and vacation pay)
- Claims and judgments (such as self insurance, contingencies)
- Pensions contributions
- Landfill closure and post-closure costs (which should never involve a school district)

## SECTION II - REQUIREMENTS

### E. ACCOUNTING ISSUES

Liabilities for compensated absences, claims and judgments, special termination benefits, and landfill closure and post-closure care costs are “normally expected to be liquidated with expendable available financial resources” at the point in time that they MATURE each period. The accumulation of financial resources in a governmental fund for eventual payment of unmatured liabilities (for example, compensated absences) does not constitute an outflow of current financial resources or result in recognition of an additional governmental fund liability or expenditure. (i.e. A governmental fund may have accumulated a healthy fund balance, but the liability must also “MATURE” to be recognized as a current liability.)

The following table presents several examples of different types of liabilities.

Note: GASB Interpretation #6 is effective at the same time the District adopts GASB #34.

*The following table includes several examples of different types of liabilities, including “normal operating transactions/regular liabilities” and “special rule liabilities”*

Type of Account	Governmental Fund Liability in Fund Level Statements	District-Wide Statement Liability	Comments
	Modified Accrual	Full accrual	
Accounts Payable - Utilities / Purchased Services	X	X	Normal operating transaction: liability is to be recorded when services have been performed or goods received.
Accounts Payable - Retainage on construction contracts	X	X	Normal operating transaction: liability is to be recorded when services have been performed or goods received. Note: In rare instances, this could be considered a contingent liability IF it is uncertain whether this will be paid.
Accrued Payroll – wages /salaries INCLUDING 26 pay teachers	X	X	Normal operating transaction: liability is to be recorded when services have been performed.
Accrued liabilities related to payroll (payroll taxes; MPSERS, etc. – NOT employee fringe benefits)	X	X	Normal operating transaction: liability is to be recorded when services have been performed.
Health, dental, vision insurance – fully insured, INCLUDING 26 pay employees coverage	X	X	Normal operating transaction: liability is to be recorded when services have been performed. “Services” refer to the employee providing a ‘service’ to the district and therefore earning the insurance coverage. For 26 pay employees, they have earned the coverage by June 30.
Health, Dental, Vision Care – Self Insurance & Workers Compensation – Self Insurance  Claims incurred AND reported to district by third-party administrator (TPA) through June 30	X	X	Special rules liability – This comes under the “claims and judgments” exception. Amounts should be recorded in a governmental fund for those health care services that have matured by June 30. For those districts using a third party administrator, this would be the June invoice (reimbursing the TPA for payments made through June 30).

**SECTION II - REQUIREMENTS**

**E. ACCOUNTING ISSUES**

Type of Account	Governmental Fund Liability in Fund Level Statements	District-Wide Statement Liability	Comments
	Modified accrual	Full accrual	
Health, Dental, Vision Care – Self Insurance & Workers Compensation – Self Insurance  Claims incurred AND reported to district by TPA AFTER June 30 (even if related to 26 pay employees)		X	For Fund level governmental fund liabilities - The claims that may be incurred in July & August for 26 pay employees have NOT come due for payment by June 30 and thus are NOT a liability at June 30 and IBNR estimates are NOT a liability at June 30.
Early Retirement Incentives (ERI) paid on payment dates specified in an agreement after year-end		X	If there is a legally enforceable due date, then that is the date to recognize the liability in the governmental fund. Until then, the liability is recordable only in the District-wide Statements.
ERI with no formal specified due date	X if retirement date prior to year end	X	Recognize this liability on the retirement date. Note that this is still the case even if the District’s practice is to pay this several months after year-end.
Compensated Absences – vested vacation/sick for current employees		X	No sick or vacation liability will exist at year-end for current employees! Record a liability in the governmental funds at the time it comes due for payment. For current employees, record sick and vacation at the time the days are taken.
Compensated Absences – vested vacation/sick for terminated employees	X if retirement date prior to year-end	X	For terminated employees, record the vested sick and vacation at the retirement date (possible exception – if there is a union contract or legally enforceable document that sets a date for payment of vested benefits, then that date is the appropriate time to recognize the liability).

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.02 GASB #33 ACCRUAL OF REVENUES IN GOVERNMENTAL FUNDS**

Receivables and revenues should be recognized on a full accrual basis at the District wide level, and for all proprietary and fiduciary funds. GASB Statement #33 provides the recognition rules for non-exchange transactions, as follows:

- For transaction taxes (sales tax, fuel tax...), recognize revenue when the transaction occurs
- For property taxes, recognize the revenue in the period levied
- For all other taxes and fees, recognize revenue when there is an enforceable legal claim or the cash is received (unless there are time requirements)
- For grants, donations & entitlements (i.e., any resources that we do not impose on others) recognize revenue when all eligibility requirements are met

In addition, GASB #33 modified the **revenue recognition rules for governmental funds**. These funds are on a modified accrual basis and can only recognize revenue if it meets the “availability” criterion. “Available” means the revenue is collected either during the year, or soon enough after the end of the year that it can be used to pay liabilities of the current year.

Prior to GASB #33, there was an exception for expenditure driven grants which could recognize revenue as soon as the expenditures were incurred, without being subject to the “availability” test. Because GASB #34 has now defined fund balance as “current financial resources,” this exception is now removed. A grant receivable that is not collected until three months after the year-end is generally not available (see last paragraph) and should not be counted as a current financial resource at year-end.

Further, GASB #38 requires that Districts disclose the time period of availability (that is, the number of days after the end of the year during which collection of revenues is considered to be available). In general, this period would be at least 30 days, and would generally be no more than 60 days. There could be some exceptions to this rule, if there is good cause. One example would be an industry that generally does not have a payables cycle of 30 to 60 days. It should be noted that because this is a possibility, the basis for conclusions of GASB #38, paragraph 42, states that the length of time during which revenues are considered available would typically fall between thirty days and one year. At the end of the year, Michigan school districts normally have accounts payable and accrued payroll, which are paid within 60 days of year-end. Thus, a district’s revenue policy generally would not extend much beyond 60 days.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.03 ACCOUNTING FOR THE RECOVERY OF INDIRECT COST**

Indirect Costs are defined as costs that are incurred for the benefit of more than one cost objective, but are not readily assignable to any program. Indirect costs serve common or joint purposes, and to identify the specific program or project served would take an effort disproportionate to the results achieved.

Each spring MDE sends Michigan public school districts preliminary indirect cost rates calculated using financial information taken from the district's prior year Comprehensive Annual Financial Report (FID). Some of the most common types of indirect costs for a district include auditing, accounting, payroll, human resources and purchasing. The MDE uses the FID amounts reported under Business Services (function 25x) and Operations and Maintenance (function 26x) when calculating the indirect cost rates. Districts must either confirm the preliminary rate calculated by the MDE or submit an application to adjust the rate. In order to recover indirect costs for the administration of federal grants, Michigan public schools must have a Michigan Department of Education approved indirect cost rate on file.

#### **Problems in Accounting for Indirect Recovery:**

- The costs that make up the indirect cost pool and subsequent indirect cost pool are from a prior year.
- If districts credit the expenditures that make up the indirect cost pool, future indirect cost rates will be lower.
- Costs for administration and operations and maintenance used to compute the indirect cost rate are recorded in the general fund while the grants are often accounted for in special revenue funds. There is no matching of revenues to expenditures for those costs.
- Districts prefer to have a direct match of revenues associated with expenditures.

#### **Recommendation:**

Our recommendation is to use the Fund Modification function "6xx" then an object code "9990" to record indirect charges at the end of an accounting period.

The recommended expenditure accounting entry would look like this:

Fund, Transaction Code, Object, State Code)

Debit	11-1-611-9990-6013	\$10,000
Debit	11-1-611-9990-6213	\$5,000
Debit	11-1-611-9990-7623	\$2,000
Debit	11-1-611-9990-7653	\$3,000
Credit	11-1-611-9990-0000	\$20,000

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

This would allow districts to bill the particular grant for its fair share of indirect costs without affecting the actual costs that make up the indirect cost pool. **There would be no need to upload the detailed accounting transaction to the FID, as there are offsetting expenditure debits and credits that will net to zero at the fund/function/object level.**

The recommendation for accounting across funds would be similar, but would include a transfer from the fund reimbursing the general fund for the indirect. The recommended accounting entry would look like this:

(Fund, Transaction Code, Function Code/Major Class, Object/Suffix, State Code)

Debit 25-1-611-9990-8513 \$30,000

Debit 25-1-611-9990-8503 \$5,000

Debit 25-1-611-9990-8523 \$2,000

Credit 25-2-101-0000-0000 \$37,000

To record the School Lunch Reimbursement of Indirect Costs in the School Lunch Fund

Debit 11-2-101-0000-0000 \$37,000

Credit 11-0-625-0990-0000 \$37,000

To record the School Lunch Reimbursement of Indirect Costs in the General Fund

#### **Steps in the Indirect Cost Pool Application Process:**

- Indirect costs incurred and recorded in the districts accounting records
- Submission of the Comprehensive Annual Financial Report (FID)
- MDE Calculation of an Indirect Rate based on FID
- Recovery of indirect from federal program
- Submission of cost reports including the grants share of indirect cost
- Process begins again.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.04 REPORTING REQUIREMENTS FOR DISTRICTS WITH A DEFICIT FUND BALANCE**

Both the Uniform Budgeting and Accounting Act (MCL 141.435) and the State School Aid Act (MCL 388.1702) prohibit a district from adopting a deficit budget and incurring an operating deficit in a fund during a fiscal year. Section 102 of the State School Aid Act requires that a district with a deficit fund balance submit a plan to the Michigan Department of Education for the elimination of the deficit. The plan must project the elimination of the deficit not later than the end of the second school fiscal year after the deficit was incurred. The plan must be approved by MDE.

A district is considered to have a deficit fund balance if;

- 1) Its General Fund balance before reserves is negative, or
- 2) Other funds have negative balances that are greater than the General Fund balance before reserves.

Following is the MDE procedure for identifying, monitoring, and reporting on districts with a deficit fund balance:

The Office of State School Aid and School Finance identifies, from the Comprehensive Annual Financial Report (FID), districts reporting deficit fund balances. Deficit districts or districts projecting a deficit fund balance may also be identified from other sources. These data must be verified with district financial records. The deficit district database is updated with current year information as available (as districts amend their budgets or as DEP information is received.)

Standard correspondence is prepared and mailed to districts as deficit fund balances are verified. The correspondence notifies districts of Section 102 provisions and requests submission of the Deficit Elimination Plan (DEP) normally within 30 days of the correspondence date. A copy of the standard Deficit Elimination Plan form (DS4511c) is sent with all correspondence. The Deficit Elimination Plan form is also available via the MDE website at:  
[http://www.michigan.gov/mde/0,1607,7-140-6530\\_6605-106599--,00.html](http://www.michigan.gov/mde/0,1607,7-140-6530_6605-106599--,00.html)

The DEP is analyzed for reasonableness. A spreadsheet analysis is conducted. Some of the checks for reasonableness include comparing the narrative explanation of the costs the district says it will cut against the numbers recorded in the DEP; comparing MDE records related to revenue against the district's DEP estimates; and looking at the district's percent of increase or decrease in revenues and expenditures over the previous year. A significant percent of increase/decrease would normally include anything greater than 5%.

The district is contacted either by phone or written correspondence related to any missing data or other problems associated with the DEP.

Approval of the DEP is verified by sending a standard approval letter, a copy of the spreadsheet reflecting the approved DEP, and a supply of the Monthly Budgetary Control Report forms with instructions. The monthly budgetary control report form is also available via the MDE website at:

[http://www.michigan.gov/mde/0,1607,7-140-6530\\_6605-106599--,00.html](http://www.michigan.gov/mde/0,1607,7-140-6530_6605-106599--,00.html)

**SECTION II - REQUIREMENTS**  
**E. ACCOUNTING ISSUES**

Monthly budgetary control reports (DS4848) from deficit districts are monitored by MDE staff. Districts failing to file the DS4848 by the due date (30 days after the end of each month starting with the month in which the DEP for the district is approved) are sent a reminder letter.

The Department of Education is responsible for maintaining statewide summary information on deficit districts. This includes:

- a) A list of deficit districts prepared or revised monthly for distribution to:
  - Superintendent of Public Instruction
  - Director of State Aid and School Finance
  - Treasury, Municipal Finance
  
- b) Not later than March 1 of each year, the Department prepares a report of deficits incurred by districts and intermediate districts in the immediately preceding fiscal year and the progress made in reducing those deficits. After approval by the State Board of Education, the report is submitted to the standing committees of the legislature responsible for k-12 education legislation, the appropriations subcommittees of the legislature responsible for k-12 education appropriations, the house and senate fiscal agencies, the state treasurer, and the department of management and budget. The department also submits interim reports as necessary.
  
- c) Deficit district information is published on the MDE website at:  
[http://www.michigan.gov/mde/0,1607,7-140-6530\\_6605-106599--,00.html](http://www.michigan.gov/mde/0,1607,7-140-6530_6605-106599--,00.html)

The Office of State Aid and School Finance monitors districts who may require further financial analysis. Criteria for selecting deficit districts requiring further financial analysis and possible action pursuant to PA72 1990:

- 1) District has been deficit for three or more consecutive years (including the current year, and
- 2) District has been deficit for five or more of the past ten years, and
- 3) District's existing deficit is greater than 5% of general fund revenues excluding incoming transfers, and
- 4) District has shown unsatisfactory progress in eliminating the deficit. This is determined by identifying one or more the following conditions:
  - a deficit increase from the previous year
  - lack of cooperation from the district in submitting reliable deficit information.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.05 FUND BALANCE**

##### **a) DESCRIPTION AND NATURE OF TRANSACTIONS**

Fund balances (equity) of school district funds will be classified either as RESERVED or UNRESERVED. The unreserved portion may be further classified as DESIGNATED or UNDESIGNATED. Generally, reserves are established to indicate a claim against assets, or when for other reasons, certain assets are not available for discretionary appropriation. Reservations and designations of fund balances originate through actions of the Board of Education of the school district to control the future use of resources. Though many of the issues discussed below relate to presenting the amount of reserved and designated fund balance, the recording of amounts under such classifications is not a substitute for the proper recognition of liabilities and expenditures. A fund balance reserve is a segregation of a portion of fund balance which is legally restricted for a specific future use, such as a reserve for encumbrances, or not available for appropriation or expenditures such as a reserve for inventories.

Where part of the fund balance is reserved, the remainder is reported as unreserved.

Within the unreserved category, a fund balance may be designated, which means that a portion of the fund balance is segregated based upon tentative future plans for utilization of the resources of a school district. Such designations are subject to change and represent resources available to finance expenditures.

The remaining fund balance that is neither reserved nor designated, is identified as undesignated. The undesignated fund balance is also reported as a part of the unreserved fund balance, and it is generally considered to be available for future appropriations subject to the budgeting methods employed by a school district.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

Nature of Transactions - Total fund balance may be segregated into a number of components under the broad categories that follow:

- 1) **Reserved Fund Balances (Major Class Code 71x)** - Reservations of fund balance are established to identify; legally restricted funds, third party claims against resources of the entity that have not materialized as liabilities at the balance sheet date, or the existence of assets that, because of their nonmonetary nature or lack of liquidity, represent financial resources not available for current appropriation or expenditure for example, inventories, prepaid expenses, and noncurrent assets (usually receivables). Such reserves are not intended as valuation allowances, but merely demonstrate that subject assets are current unavailable to pay current expenditures. If a valuation allowance is required, it should be presented as a reduction of the carrying amount of the asset. In addition, if collect ability of an inter-fund receivable is doubtful, consideration should be given to reclassifying the amount as an equity transfer.
- 2) **Unreserved Fund Balances - Designated (Major Class Code 75x)** - Designations of fund balance are established to identify tentative plans for or restrictions on the future use of financial resources. Such should be supported by definitive plans and approved by the Board of Education. Examples of such designations include the earmarking of financial resources for capital projects and contingent liabilities.
- 3) **Unreserved Fund Balances – Undesignated (Major Class Code 74x)** - The fund balance remaining after reduction for reserved and designated balances is identified as the unreserved and undesignated fund balance. That amount is sometimes referred to as the “amount available for future appropriation”. However, care should be exercised in the use of that term, because the amount available may differ depending on the budgeting methods employed by the school district.
- 4) **Changes in Fund Balances** - Changes in the aggregate fund balances usually result from the following:
  - Excesses (deficits) of revenues and other sources over (under) expenditures and other uses
  - Residual equity transfers which are defined as nonrecurring or non-routine transfers of equity between funds. (GASB Cod. Sec. 1800.106).
  - Adjustments meeting the criteria of FASB Statement No. 16, Prior Period adjustments.

**SECTION II - REQUIREMENTS**  
**E. ACCOUNTING ISSUES**

**b) ACCOUNTING CONSIDERATIONS**

**1) Reserved and Designated Fund Balances** - The following principles are important to an understanding of the accounting for reserved and designated fund balances:

- Establishing required reserved fund balances may create or increase a negative unreserved and undesignated fund balance
- Designations of fund balance may not create or increase a negative unreserved and undesignated balance at balance sheet date regardless of the amount of fund balance that may have existed at the time of making the designation.
- Reserved and designated fund balances represent only classification of aggregate fund balances and should not be used to absorb future charges or credits.
- When no longer required, reserved and designated fund balances should be returned to the unreserved and undesignated fund balance.

**2) Reserve for Encumbrances**

Encumbrances represent commitments related to contracts for unperformed services and undelivered goods which were appropriated in the current budget year. If an encumbrance is supported by a legal obligation to fulfill such a commitment, an amount equal to those encumbrances should be reclassified from the unreserved and undesignated fund balance to a “reserve for encumbrance” as a demonstration of a contractual commitment against the unreserved fund balance. Please note, however, that staff salaries are charged to the time period in which the services are rendered and should not be charged to a reserve for encumbrances.

**3) Reserves for Inventories, Prepaids, and Long-Term Assets**

Reserves for inventories, prepaid and long-term assets are established to convey that certain assets already committed to other purposes are not available for discretionary expenditures. Though establishing a reserve for inventories determined on the consumption basis and prepaid expenses is optional, reserve accounting is required in cases where noncurrent assets are present.

**4) Designated Fund Balances**

Designations of fund balances are usually recorded as a demonstration of future expenditure intentions or restrictions as distant from unperformed (executory) contracts and are reported as encumbrances. Designated fund balances are established by reclassifying amounts equivalent to the designations from the undesignated and unreserved fund balances to separately presented designated balances.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **c) FINANCIAL STATEMENT PRESENTATION AND DISCLOSURE**

##### **Changes in Fund Balance**

GASB Cod. Sec. 2200.009 requires the presentation of “change in fund balances”. That information may be presented on a “combined statement of revenues, expenditures, and changes in fund balances”. The fund balance reconciled in that statement may be either the unreserved and undesignated fund balance or the total fund balance. If the statement presents changes in the total fund balance, material changes in reserves and designations should be disclosed in notes to the financial statements.

##### **Fund Balance of Funds Other Than the General Fund**

The fund balances of other school district fund types that represent assets restricted for special revenues, capital projects, debt service, and special assessments may be classified as reserved or designated. Designations in such funds may relate to identified portions intended for a particular purpose or to the fact that all balances are restricted to the purpose of the fund type. (However, many school districts do not classify such balances as designated on the basis that the nature of the respective fund types provides adequate information regarding intent.) The following additional comments relate to other district fund types.

##### **Special Revenue**

The above discussion of fund balance reserves and designations applies to special revenue funds. Negative balances in such funds are rare because expenditures are not usually incurred in advance of the receipt of revenues or an event (signed grant agreement) that would support the accrual of revenues equivalent to the expenditures incurred.

##### **Debt Service**

The fund balance for debt services funds is held only for meeting debt service requirements. The fund balance of this type usually determines the “amount available in debt service funds” shown as part of the contra to liabilities recorded in the general long-term debt account group.

##### **Capital Projects**

Grant financial funding of capital projects is recorded by matching grant revenues and related expenditures. However, bond proceeds to be used for capital projects are recorded in capital project funds at the time those proceeds are received, irrespective of when expenditures are incurred. The fund balance usually represents unexpended resources designated for specific projects or reserved for outstanding encumbrances.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.06 ACCOUNTING FOR INTERNAL SERVICE FUNDS**

An Internal Service Fund (ISF) is a form of Proprietary Fund. The accounting and reporting for these funds is on a full accrual basis.

An Internal Service Fund may be used to account for activities that involve the school district providing goods or services to other funds or activities of the district on a fee basis. Because proprietary funds are accounted for differently than traditional governmental funds, we encourage districts to consult with their school district auditor before establishing an internal service fund.

The ISF should charge the governmental funds for goods and services on a "cost reimbursement basis." Implicit in this requirement is the understanding that the obligations of the ISF must be currently fully-funded on the full accrual basis - That is the ISF should not report a deficit fund balance and must accrue all of its long-term obligations. The full cost of its services should be estimated and charged to the governmental funds each year.

The ISF records amounts charged to other funds as revenue for services provided, and records expense for the cost of those services. The governmental funds must report amounts paid to the ISF as expenditures in the appropriate function. Accordingly, this revenue and expenditure will be eliminated during the government wide consolidation of the Statement of Activities under GASB #34 to eliminate double reporting of the grossed up revenue and expenditure.

The Michigan chart of accounts and Financial Information Database (FID) do not allow for inter-fund transfers to be made to or from internal service funds. All transactions between the ISF and governmental funds must be reported in revenue and expenditure accounts for FID. This is necessary to avoid double counting of revenue and expenditure when the State of Michigan performs consolidated reporting for districts.

Use of Internal Service Funds is optional.

#### **Districts use the funds to accomplish specific goals:**

- To pool the costs of activities which benefit multiple funds in one location for accounting purposes.
- To allow governmental funds to recognize the current impact on expenditure and fund balance of funding long-term obligations.
- To ensure that long-term obligations are funded currently so that future shortfalls do not occur.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **Examples of School District Internal Service Funds**

- Severance obligations and early retirement incentives
- Fringe benefits
- Risk management activities
- Bus fleets
- Data services

#### **Challenges in using an Internal Service Fund**

- Use of an ISF creates additional complexity in accounting matters and could result in increased costs
- The decision to use an internal service fund should consider long-term consequences. A District should not establish an ISF for a short period of time and then return to traditional funding for those same costs.
- The implications of full-accrual accounting may not be widely understood by all financial statement users, including those making budget decisions.

**SECTION II - REQUIREMENTS**  
**E. ACCOUNTING ISSUES**

**Sample Journal Entries Related to Internal Service Fund**

**Example 1 Facts:**

- School District entered into an Early Retirement Incentive (ERI) program with its teachers and administrators.
- Agreement entered into 5/01/06
- District makes monthly payments of \$20,000 made to 403(b) for 60 months beginning 9/01/06
- Liability calculated at \$1,080,000 at 06/30/06 per GASB #47.

**Journal Entries for Example 1**

Establish Liability in Internal Service Fund:

DR ERI Expenditure (81-259-2210) \$1,080,000

CR ERI Payable (81-461-0000) \$1,080,000

Charge Governmental Fund for Services Governmental Fund:

DR Various Expenditure Accounts Based on Employees Function, object code 2210 Total \$1,080,000

CR Cash/Due to Other Funds Total \$1,080,000

Record Revenue in Internal Service Fund:

DR – Cash/Due from Other Funds Total (81-101/131-0000) \$1,080,000

CR – Revenue Services Provided Other Funds (81-197-0000) \$1,080,000

Monthly Payment to 403(b)

DR ERI Payable (81-461-0000) \$20,000

CR Cash (81-101-0000) \$20,000

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **Example II Facts**

- School District runs its bus fleet through an Internal Service Fund
- Charges other funds monthly for services

#### **Journal Entries for Example II**

Pay Recurring Transportation Costs in Internal Service Fund:

DR Transportation Expense (81-271-xxxx) \$

CR Cash (81-101-0000) \$

Record Depreciation Expense in Internal Service Fund:

DR Depreciation Expense (81-711-7710) \$

CR Accumulated Depreciation (81-262-0000) \$

Charge Governmental Fund for Services:

Governmental Fund

DR Expenditures (XX-271-31xx) \$

CR Cash/Due to other Funds (XX-101/411) \$

Record Expenditures in the Governmental Fund

Record Revenue in Internal Service Fund:

DR Cash/Due from Other fund (81-101/131-0000) \$

CR – Revenue Services Provided Other Funds (81-197-0000) \$

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.07 ACCOUNTING FOR ADVANCE REFUNDING OF LONG-TERM DEBT**

Advance refunding of long-term debt affects not only the Debt Retirement Fund, but also the General Long-Term Debt Account Group. The transactions must also be disclosed in the school district's Annual Financial Report. A district must be cognizant that advance refunding of debt may create an arbitrage condition during the interim between receipt of funds from the new bond issue and the actual date when the funds are disbursed and the old bond issue liquidated. An example of arbitrage would be selling new bonds with a lower interest rate than the outstanding bonds and collecting interest on the proceeds of the new bonds for a period of time before the refunding takes place.

There are prescribed procedures that must be adhered to when proceeding with the refunding of a bond issue involving irrevocable trusts and restrictive types of investment securities of the refunding bond proceeds.

The uniqueness of this type of transaction recommends that the school district consult with bond counsel and auditors to insure legal compliance and proper accounting of the bond transaction.

Below is an example of an accounting transaction for advance refunding of debt. It should be noted that this is just one example. There may many others. You should refer to authoritative governmental accounting literature for specifics.

Example: The school district intends to refund bonds totaling \$4,055,000 on May 1st. Proceeds of \$4,010,000 from the refunding will be received on February 15th. The district has been advised to put these funds into an escrow account to earn interest.

#### Debt Service 1993 Fund (Fund 32)

2/15/xx Proceeds are placed in escrow:

32-181-0000 Investments-Escrow	\$4,010,000
32-596-0000 Proceeds from Bond Refinancing	\$4,010,000

5/01/xx Interest Earned from February 15th to May 1st

32-181-0000	\$ 45,000
32-151-0000	\$ 45,000

05/01/xx Old Bonds are Paid Off

32-512-7320 Payments to Bond Escrow Agent	\$4,055,000
32-181-0000 Investments-Escrow	\$4,055,000

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.08 SALE OF SCHOOL PROPERTY**

Districts should contact Bond Counsel for determining the distribution of proceeds from the sale of property purchased with bond proceeds.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.09 TAX-EXEMPT INTEREST INFORMATION AND REBATE ARBITRAGE REQUIREMENTS**

##### **a) DESCRIPTION OF THE ISSUE**

School districts who issue debt obligations must comply with *Information and Rebate-Arbitrage Requirements* of the Internal Revenue Service. The following is a brief discussion of the requirements that a school district must be concerned with when issuing debt.

Under the Internal Revenue Code of 1986, all issuers of tax-exempt obligations must report certain information about bonds to the Internal Revenue Service. The reporting forms may be obtained from the IRS. "Obligations" for purposes of these reporting requirements include tax-exempt bonds or debt obligations of a governmental unit such as State School Aid and tax anticipation loans, installment purchase agreements, or finance leases.

##### **b) REBATE - ARBITRAGE**

The "Rebate" provision (Section 148 of the Internal Revenue Code of 1986) requires governmental issuers such as school districts to pay to the federal government a portion of arbitrage earned on funds derived from tax exempt debt. With certain stated exceptions, the requirement applies to all tax exempt bond and note issues. The code provides that failure of an issuer to rebate causes the loss of federal tax exemption or subjects the issuer to substantial penalties and interest.

It is advisable that a determination of the rebate amount be made at least every year. The amount required to be paid to the United States for such period, including the earnings thereon, must be set aside each year in a rebate fund. The general rebate requirement is that the school district compute its arbitrage for successive five-year periods beginning with the date of issuance and must pay at least 90% of the arbitrage to the federal government within 60 days of each computation period (*ABC's of Arbitrage*, 2002 edition, State and Local Government Law Section, p. 207 American Bar Association.) Generally, rebate payments to the IRS cease after the construction fund or proceeds of the obligation have been entirely spent.

It is critical that issuers establish and maintain the accounting and other administrative procedures to insure compliance with the federal requirements.

At the time of the rebate payment, a legal opinion may be required that the calculations of the amount of the rebate have been made in compliance with provisions of the Internal Revenue Code.

Transactions of this type should be reviewed with the school district's bond counsel and auditors to insure legal compliance and proper accounting of the IRS Information and Rebate-Arbitrage requirements.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.10 TRANSACTIONS FOR RECORDING ENERGY CONSERVATION IMPROVEMENT CONSTRUCTION PROJECTS**

##### **a) DESCRIPTION OF THE ISSUE**

A local school district or an intermediate school district may pay for energy conservation projects from operating funds of the school district or from the proceeds of bonds or notes issued for energy conservation improvements, or may enter into contracts in which the cost of the energy conservation improvement is paid from the savings which result from such improvements. This may be done without approval by voters of the district. The main accounting concerns of the school district are:

- Which fund should be used to account for such transactions?
- How should these be recorded in the financial statements?

It is recommended that the proceeds from the issuance of energy bonds, notes and other forms of obligations along with energy project related investment interest earnings be recorded in a capital projects fund. The energy project expenditures should also be reported in a capital projects fund. Act 22 of the Public Acts of 1998 allows school districts to use the capital projects fund to facilitate accountability for energy conservation projects.

The general fund should be used to account for payments on energy bonds and notes. An alternative would be to establish a debt service fund. However, this would require a transfer from the general fund to make the debt service payments.

##### **b) REFERENCE**

Please refer to Section III. Sub-section C.05 of this manual for a series of sample accounting entries that reflect Energy Conservation Improvement Projects. Public Act 22 of 1985 deals with Energy Transactions.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.11 ACCOUNTING FOR SPECIAL EDUCATION CENTER PROGRAMS AND COMMUNITY SERVICE ACTIVITIES**

##### **a) DESCRIPTION OF THE ISSUE**

Inclusion of certain revenue and expenditure items in the General Fund tend to overstate the measures traditionally used to compare educational costs between K-12 school districts. In an attempt to alleviate this comparability problem the Bulletin 1022 Referent group recommends moving some of these revenues and expenditures from the General Fund to a Special Revenue Fund. The options are as follow:

- Districts that operate special education center programs may report such revenues and corresponding expenditures in special education fund section of the Comprehensive Annual Financial Report (FID).
- Non-educational Child Care Fees, Museums, Theaters, Community Recreation Centers, Senior Citizens Activities, Public Libraries may be reported in the Community Service Fund.

##### **b) MANDATORY REPORTING**

State reporting for the Center Program revenues and expenditures in Special Education Fund and reporting of the items listed above in the special revenue fund is mandatory, if significant. Significance will be decided by each school district. One suggestion to determine significance is whether the inclusion of these items in the general fund has a notable effect on per pupil revenues and expenditures. In summary, districts must use the special revenue fund or special education fund, as explained above, if the amount involved is significant to the district's per pupil revenues and expenditures.

##### **c) QUESTIONS AND ANSWERS**

Q- 1 The General Fund contains assets and liabilities related to enrichment and child care programs. Must these be moved to the special revenue fund when the accounting treatment changes?

A-1 This is up to the local Board of Education.

Q-2 May (or should) the salary and fringes of the adult education director be prorated between the general fund and special revenue fund if certain community service activities are moved to the special revenue fund?

A-2 From an accounting standpoint, it should be prorated.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **d) STATE REPORTING**

Accounting for Special Fund Revenue

Use the appropriate local revenue category (Major class codes 161-181) to record revenues collected from any sales of food, merchandise, tickets, gate receipts, and admission.

Use Major Class Code "192-Private Sources" to record private and local grants, along with donations.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.12 DISCUSSION OF SUPPLIES AND EQUIPMENT CLASSIFICATIONS**

A school district can take two basic approaches to distinguish between supplies and equipment:

- adopt a predetermined list of items, classifying each entry as either a supply or an Item of equipment; or
- adopt a set of criteria to be used in making its own classification of supply and equipment items.

Several publications have provided detailed lists of material items used in school district operations, identifying each entry as either a supply or equipment item. These lists have been helpful to many users, but they have at least four inherent drawbacks:

- Various state and federal aid programs offer supply/equipment categorizations which conflict with one another;
- Technological and philosophical changes in education continue to occur at an ever increasing pace. It is impractical to list and classify the thousands of materials and devices used in districts today, particularly in the vocational education curricula. Therefore, without periodic updates, supply/equipment lists quickly become obsolete;
- Classifications of certain items change, due to changes in price and technology. For example, most districts classified hand-held mini calculators as equipment several years ago when they cost over \$100. Now that the price of these items has dropped to the \$5 to \$25 range, many districts are changing the classification of these items to supplies.
- Users tend to treat the lists as comprehensive and up to date, even when warned otherwise.

For these reasons, developing a universally applicable and easily updatable supply/equipment list is impractical. Instead of presenting a list which might raise as many issues as it would propose to resolve, it is suggested that the distinction between supplies and equipment can better be made through consistent, statewide application of uniform criteria.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **CRITERIA FOR DISTINGUISHING SUPPLY AND EQUIPMENT ITEMS**

Federal, state and local laws/regulations present conflicting criteria for distinguishing between supplies and equipment. The criteria below are based on a combination of the most practical guidelines from these sources. Unless otherwise bound by federal, state or local law, districts should use these criteria in their supply/equipment classification decisions. In cases where the distinction is unclear, the district, as always, should apply reason and good judgment in making its decision.

#### **a) EQUIPMENT ITEMS**

An equipment item is any instrument, machine, apparatus, or set of articles which meets ALL of the following criteria:

- It does not lose its identity through fabrication or incorporation into a different or more complex unit or substance;
- It retains its original shape, appearance, and character with use;
- It is nonexpendable; that is, if the item is damaged or some of its parts are lost or worn out, it is more feasible to repair the item than to replace it with an entirely new unit;
- Under normal conditions of use, including reasonable care and maintenance, it can be expected to serve its principal purpose for at least one year and is not consumed in use;
- Its cost may also affect the decision. If the item costs less than an established, predetermined amount, then it is treated as a supply expense.

#### **b) SUPPLY ITEMS**

An item should be classified as a supply if it does not meet ALL the stated equipment criteria.

## SECTION II - REQUIREMENTS

### E. ACCOUNTING ISSUES

#### ILLUSTRATION

In an effort to resolve the need to differentiate supplies and equipment without exhaustive lists, the following flowchart provides a set of criteria for distinguishing equipment from supply items, listed in priority order. At the first "NO", the item is declared to be a supply, not equipment. This criteria was adapted from the federal *Financial Accounting for Local and State School Systems, 2003 Edition*.

(Listed in Priority Order) At first question answered with a "No" - Item is declared to be Supply rather than Equipment.

- |    |  |             |
|----|--|-------------|
| A. | Lasts more than one year?<br>YES   | NO (Supply) |
| B. | Repair rather than replace?<br>YES   | NO (Supply) |
| C. | Independent unit rather than being incorporated into another unit item?<br>YES                                 | NO (Supply) |
| D. | Retains original shape and appearance?<br>YES  | NO (Supply) |
| E. | Exceeds arbitrary or predetermined cost amount, mandated by district, state or other governmental unit?<br>YES | NO (Supply) |
|    | EQUIPMENT  |             |

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **E.13 CAPITAL PROJECTS FUND (FORMERLY BUILDING AND SITE FUND)**

##### **DESCRIPTION OF ISSUE**

The Bulletin 1022 *Michigan Public School Accounting Manual (Manual)* has been revised to delete the title, "Building and Site Fund" and replace it with the term "Capital Projects Fund" (CPF). CPF is a term used in governmental accounting for municipalities and is being adopted to help clarify school district accounting.

##### **DISCUSSION**

The basic concept of the old Building and Site Fund is that school districts need a fund other than the General Fund to account for monies used to purchase and/or develop school sites, and the construction or renovation of school buildings. The *Manual* previously used the term "Building and Site Fund" to describe this fund. There was considerable confusion caused by using the term "Sinking Fund" interchangeably with the term "Building and Site Fund." Section 380.1212 of the School Code provides for a "Sinking Fund." This "fund" is actually a subset of the old Building and Site Fund, as are the many other capital projects funds established to provide a basis of accountability for resources provided for a particular purpose.

In order to alleviate some of this problem, the Department of Education has renamed the Building and Site Fund as the "Capital Projects Fund." A Capital Projects Fund may have the following sources of revenue:

- Proceeds of Bond Issues - such proceeds may be deposited in a capital projects fund. The funds are then used as needed for the purposes specified in the bond issue approved by the voters.
- Sinking Fund Millage - As described in section 308.1212 of the School Code, local school districts may levy up to five mills, the proceeds to be used for purchase of real estate for sites for, the construction or repair of school buildings
- Transfers From the General Fund - Section 18.2 of the State School Aid act provides that up to 20 percent of the funds provided to a district under Article 2 of the State School Aid Act may be transferred to a Building and Site Fund (hereinafter referred to as a Capital Projects Fund) and/or a Debt Retirement Fund.
- Sale of School Property (Net of proceeds required to be deposited in Debt Retirement Fund).

Therefore, as outlined above, the Capital Projects Fund is a higher order concept than the Sinking Fund. The proceeds of Sinking Fund millage are deposited into a Capital Projects Fund.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **GENERAL RESTRICTIONS**

The concept of a capital projects fund is that such funds are to be used for non-routine capital items. Examples include the construction of new buildings, major remodeling of buildings, and acquisition of equipment to equip newly constructed or remodeled buildings. Routine operation, maintenance and repair are to be accounted for in the district's General Fund.

Additionally, the language in section 380.1212 of the School Code requires that the district's independent auditor examine the use of sinking fund monies to ascertain that the district has expended the funds in an acceptable manner.

Bond Issue Funds deposited in the Capital Projects Fund must be used in accordance with the ballot language as approved by the district's voters.

#### **SPECIFIC RESTRICTIONS**

For any given capital project there will most likely be restrictions that will be unique to the project. It is important that the school district maintain adequate documentation to enable auditors and other monitors to verify that funds are spent in accord with the project's parameters.

For example, language in the School Code requires that bonds for technology be paid off within the "usable life" of the equipment. "Usable life" for the given items needs to be clearly defined somewhere in the bond issue documentation, and the bond payment schedule must reflect that repayment was made in accordance with this code.

## SECTION II - REQUIREMENTS

### E. ACCOUNTING ISSUES

#### E.14 ECONOMIC DEVELOPMENT TAX INCENTIVE PROGRAMS

##### INTRODUCTION

Several State laws enable municipalities to attempt to stimulate economic growth and commercial and industrial expansion in Michigan. These laws allow tax revenue to be diverted or “captured” from other taxing units, such as school districts, almost totally at the discretion and initiative of local municipalities seeking to influence business location or expansion in their communities. School districts annually lose substantial amounts of tax revenue in this manner. When faced with this situation, the best course of action available to a school district is to become knowledgeable of the governing statute and exercise whatever options may be allowed under the law.

##### DISCUSSION OF THE ISSUE

State laws provide two distinct approaches which allow taxpayer money to be used to stimulate economic development; Tax Increment Financing (TIF) and Tax Abatements.

##### **Tax Increment Financing**

Tax increment financing is used by local governments to finance infrastructure improvements. It allows public projects in a designated area to be financed by diverting or “capturing” revenue derived from increases in property value as compared with an established base valuation. An example of how this works is shown below:

Initial Assessed Value of Tax Increment Area	\$10,000,000
Assessed Value of new private development	\$1,500,000
Inflationary Increase in value of existing property	\$500,000
Total Assessed Value	\$12,000,000
<b>LESS:</b>	
Initial Assessed Value	\$10,000,000
<b>Captured Assessed Value</b>	<b>\$2,000,000</b>

In the above example, all taxes generated from millage levied by local taxing units such as school districts on the \$2,000,000 of “captured” assessed value is diverted to the use of whatever Tax Increment Financing (TIF) authority is in place in the area. A school district levying 18 mills could lose at least \$36,000 in tax revenue on the increased value of “captured” property within the TIF authority for each year of the life of the authority.

Four State laws authorize tax increment financing in Michigan; the Downtown Development Authority (DDA) Act, P.A. 197 of 1975; the Tax Increment Finance Authority (TIFA) Act, P.A. 450 of 1980; the Local Development Financing (LDF) Act, P.A. 281 of 1986; the Brownfield Redevelopment Financing (BRF) Act, P.A. 381 of 1996.

##### a) **Downtown Development Authority (DDA) Act, P.A. 197 of 1975**

The DDA Act may be used by a city, township, or village in an area of the downtown of a municipality zoned and used principally for business. The purpose of a DDA is to prevent deterioration and promote economic growth within a business district by developing, adopting, and implementing development plans. The Authority may construct, rehabilitate, equip, improve,

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

maintain, or operate any building within the downtown district for public or private use. To support these activities, the Authority may obtain revenue from several sources including:

- Incremental tax revenue on “captured” property. Beginning in 1994, plans may only capture school taxes to repay contracts and advances entered into before August 19, 1993 and to repay obligations issued before 1995 to finance a project. (Additional conditions and exceptions apply.)
- Tax revenue generated from up to 2 mill taxing authority.
- Proceeds from revenue bonds.
- Leased or owned property rented for profit.
- Loan proceeds from the governing municipality.
- Proceeds from State and federal grants or public/private contributions.

#### **b) Tax Increment Finance Authority (TIFA) Act P. A. 450 of 1980**

The TIFA Act authorized cities to create a TIFA district, with specific boundaries, anywhere in the city, not just downtown. The TIFA is governed by a 7-13 member board of directors appointed by the city council. The purpose of a TIFA is to halt a decline in property values and promote growth within an area designated as a TIFA district. A TIFA has broad powers to plan and implement projects within the boundaries of the TIFA district. To support its activities, a TIFA may:

- “Capture” all taxes levied by any taxing authority within the TIFA district on incremental property values above those established at the inception of the TIFA. Beginning in 1994, plans may only capture school taxes to repay contracts and advances entered into before August 19, 1993 and to repay obligations issued before 1995 to finance a project. (Additional conditions and exceptions apply.)
- Plan, develop, acquire, and control property.
- Borrow from the governing city council.
- Issue revenue bonds to finance large projects.
- Receive public and private contributions as well as State and federal grants.

P.A. 280 of 1986 amended the Tax Increment Finance Authority Act to prohibit the establishment of a new authority or expansion of an existing authority district after December 31, 1986. Existing authorities were not eliminated under this legislation and will continue to function indefinitely or until they are dissolved by their governing body.

#### **c) Local Development Financing (LDF) Act, P.A. 281 of 1986**

The LDF Act succeeds P.A. 450 and is an attempt to improve on the previous legislation. Unlike either P.A. 197 (DDA) or P.A. 450 (TIFA), Public Act 281 (LDF) can only be used to provide public facilities for manufacturing and agricultural processing activities. The authority may, however, be created by a city, village, or urban township, not just by a city as under P.A. 450. Beginning in 1994, plans may only capture school taxes to repay contracts and advances entered into before August 19, 1993 and to repay obligations issued before 1995 to finance a project. (Additional conditions and exceptions apply.) P.A. 281 attempted to remedy other deficiencies by:

- Not allowing for the capture of a facility’s taxes if the construction of the facility has the

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

effects of transferring 50 or more jobs from another municipality unless permission is given by the affected community.

- Excluding debt millage.
- Requiring Board of Control to consist of one representative appointed by the county board of commissioners, one representative of any local community college or junior college whose revenues are affected by the plan junior college whose revenues are affected by the plan two representatives of any unit of government levying at least 20 percent of total ad valorem property taxes in the development area (school district), and not less than seven members appointed by the chief executive officer of the city, village, or urban township creating the authority.

The reduction in school operating millage resulting from the adoption of Proposal A created an uncertainty for LDFs, DDAs, and TIFAs to meet their obligations. The Legislature passed Acts 280, 281, 282, P.A. 1994, to help reduce the impact of the school finance reform on DDAs, TIFAs, and LDFs respectively. The new amendments provide authorities, with eligible obligations, a three-step process to fund the related debt. If the first step does not provide sufficient funding, the authority goes to the next step.

The three steps are: step 1) captured school revenues; step 2) captured revenues from nonschool millage; and step 3) the State will provide reimbursement to the authorities up to the amount that would have been captured if the 1993 school millages were still being levied.

#### **d) Brownfield Redevelopment Financing (BRF) Act P.A. 381 of 1996**

The BRF Act may be used by a city, township, village or county to capture taxes from a site of environmental contamination in order to pay for clean-up costs of the site. The plan may capture local school district operating taxes and the SET, but only if the work done at the property is consistent with a work plan approved by the Department of Environmental Quality (DEQ) before January 1, 2001.

As noted, each authority has specific powers and limitations. For a detailed analysis of each, the individual statute should be consulted. Additional information may be obtained from the Office of Revenue and Tax Analysis of the Michigan Department of Treasury (517) 373-9002.

#### **e) Smart Zones Act, P.A. 248 of 2000**

Smart Zones expanded the LDFA Act to allow the creation of up to 10 “Certified Technology Parks”, a type of high technology industrial park. In 2002, additional legislation allowed the MEDC to designate an additional 5 zones. The Smart Zones may capture local school operating taxes and school education tax (SET).

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

#### **Tax Abatements**

Tax abatements were designed to provide a stimulus in the form of significant tax incentives to industrial and commercial interests to renovate and expand aging plants and commercial facilities in Michigan. There is one primary instrument for providing tax abatement incentives; The Plant Rehabilitation and Industrial Development District Act, P.A. 198 of 1974.

Other tax incentives have recently been permitted in an effort to revitalize economically distressed areas of the state, both urban and rural; these include the Michigan Renaissance Zone Act, Neighborhood Enterprise Zones, the Commercial Rehabilitation Act, the Obsolete Property Rehabilitation Act and personal property tax waivers.

#### **a) The Plant Rehabilitation and Industrial Development District Act, P.A. 198 of 1974**

The legislative body of a local governmental unit (city, township, or village) is authorized under P.A. 198 of 1974 to issue an industrial facilities exemption certificate to a replacement facility (including a restored facility), a new facility or a speculative building. A facility issued an exemption certificate is exempt for ad valorem taxation but is subject to the industrial facilities tax. Industrial property eligible for an exemption certificate includes land improvements, buildings, structures, and other real property and machinery, equipment, furniture, and fixtures used in the manufacturing and processing of goods, materials. Recent legislation now includes creation and synthesis of biodiesel fuel, high technology activity, qualified start-up businesses and logistical optimization centers as types of activities that qualify for an IFT exemption. The duration of the exemption is left to the discretion of the local legislative body but may not extend beyond 12 years after the completion of the facility.

The manner in which the industrial facilities tax is calculated and the amount of the tax are dependent on the type of facility qualifying for the exemption. For a new facility or speculative building, the total taxable value of the facility (excluding land) each year is multiplied by one-half of the total mills levied by all taxing jurisdictions in the district, except that the Michigan Jobs Commission may require the facility to pay 0, 3, or all 6 of the State Education Tax Mills. The net effect is that the industrial facilities tax is about 50% of what taxes would be if the facility were subject to general ad valorem property taxation. New facilities granted an abatement before 1994 pay one-half of the 1993 school operating millage rate and no State Education Tax. For a replacement or restored facility, the SEV of the obsolete facility (excluding land) in the year preceding the issuance of the industrial facilities exemption certificate is multiplied by the total mills levied by all taxing jurisdictions in the district. The industrial facilities tax, in effect, exempts from taxation the increased value of the replacement or restored facility for a period of up to twelve years. Industrial facilities tax receipts are distributed among the taxing jurisdictions in the same manner as ad valorem property taxes, except that to the extent a school district is "in formula" the share of the tax attributable to local school operating mills (generally the first 18 mills levied on non-homestead property) and special education and vocational education mills levied by ISDs are deposited in the State school aid fund. Upon expiration of the certificate, the abated facility is placed on the ad valorem property tax roll.

#### **b) Michigan Renaissance Zone Act, P.A. 376 of 1996**

A State administrative board with recommendations from the renaissance zone review board is authorized under P.A. 376 of 1996 to designate 11 regions in Michigan as Renaissance Zones.

## **SECTION II - REQUIREMENTS**

### **E. ACCOUNTING ISSUES**

Effective January 1, 1997, an individual living in or a business located in a Renaissance Zone will receive an exemption, deduction or credit from certain state and local taxes for up to 15 years. Enabling legislation which was passed after P.A. 376 exempts individuals and businesses in a Renaissance Zone from various taxes including, but not limited to, the following State and local taxes: Michigan Single Business Tax, Michigan Income Tax, Michigan's 6-mill State Education Tax, Local Personal and Real Property Tax, Local Income Tax and Utility Users Tax. The obvious impact to schools is a reduction in local tax revenue, however school tax revenue lost as result of exempting property under this act is reimbursed by the State to the schools via section 20 of the State Aid Act.

PA 259 of 2000 and subsequent legislation created 20 Agricultural Processing Renaissance Zones that provided tax breaks for specific areas that meet the agricultural processing requirements

PA 512 of 2002 created one Alternative Energy Renaissance Zone for a term not longer than 20 years that promotes research, development and manufacturing of alternative energy technology.

PA 266 of 2003 created tool and die renaissance recovery zones to allow eligible tool & die businesses to qualify for tax breaks associated with renaissance zones. These recovery zones are industry based and are company specific. The boundaries of the zone may include more than one local unit.

Other legislation created renaissance zones for renewable energy and forest product processing zones.

#### **c) Neighborhood Enterprise Zone Tax Abatements, P.A. 147 of 1992**

This abatement provides for the development, rehabilitation of residential housing located in eligible distressed communities. In lieu of general property taxation for up to 15 years after rehabilitation or completion of a facility that is granted an exemption, certificate holders pay a specific tax known as the Neighborhood Enterprise Zone Tax. For the Neighborhood Enterprise Zone Tax, the ISD millage for in-formula districts is paid to the School Aid Fund. Applications are filed, reviewed and approved locally while the State Tax Commission is responsible for final approval.

There are different tax rates and bases depending on the type of facility that qualifies for the NEZ exemption. The most common type is a new facility that is a principal residence where the tax rate on the property is the 1/2 the statewide average on principal residence property from the preceding year. In 2006, the NEZ millage rate on a principal residence new facility was 16.95 mills.

A rehabilitated facility has a frozen value and pays no taxes on the improvements. A recent legislative change creates a homestead facility which provides a 50 percent tax exemption on local unit and county operating millage.

A homestead facility must be located within an established NEZ and be purchased or transferred to the owner after December 31, 1997. Please see the State tax Commission website for further information.

#### **d) Commercial Rehabilitation Act, P.A. 210 of 2005**

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This Act offers owners of certain rehabilitated commercial facilities in certain districts a property tax abatement for up to 10 years. The property must meet the required obsolescence of the Act as determined and certified by the local unit assessor. A property must receive final approval from the State Tax Commission. The property taxes are based on prior year's taxable value for millage other than school related millages. There are no tax cuts for school millages.

A certificate holder remits a commercial rehabilitation tax in lieu of the ad valorem property tax. For the commercial rehabilitation tax, the local school operating millage and ISD millage for in-formula districts are remitted to the School Aid Fund.

#### **e) Obsolete Property Rehabilitation Act, P.A. 146 of 2000**

This Act provides commercial and commercial housing property tax exemptions for 1 to 12 years from the ad valorem property tax. The property that is rehabilitated must meet obsolescence requirements as provided by the Act and be located in a qualified governmental unit.

The exemption from ad valorem property taxes does not include land or personal property. Certificate holders pay a specific tax known as the Obsolete Properties Tax. The value of the property before rehabilitation is frozen and is subject to the full millage rate of the local unit in which it is located. The increased value of the facility from rehabilitation is exempt from all local unit millage. The State Treasurer can grant an exemption of 1/2 of the local school operating millage and the SET for up to 25 certificates a year. For the obsolete properties tax, the local school operating millage and ISD millage for in-formula districts are paid to the School Aid Fund.

#### **f) Personal Property Tax Waiver, P.A. 328 of 1998**

This Act provides a 100 percent personal property tax exemption for specific businesses (primarily engaged in manufacturing, mining, research and development, wholesale trade or office operations) located in eligible distressed communities. The exemption is for all new personal property placed in a district established by a local unit of government which also determines the number of years granted for the exemption. The State Tax Commission is responsible for final approval. See the State Tax Commission website for approved exemptions.

### **IMPACT**

Although school districts and other local governmental taxing units are thought to be most heavily impacted by Tax Increment Financing, the State of Michigan is a major contributor through the school aid fund. Normally, when taxable value increases, school aid payments decrease proportionately. However, the School Aid Act has been amended to exempt increased taxable value included in a tax increment plan from the calculation of State aid. School aid payments to these districts are therefore increased from the levels that they would otherwise be. Thus, State school aid fund monies are diverted to replace monies captured by the TIFs. Similarly, the State school aid fund replaces monies lost as a result of exempting property within renaissance zones.

Tax increment financing affects the State budget in another manner, also. When Property Tax Abatements are used as an inducement for industrial and commercial development, the business that receives the abatement pays a specific tax in lieu of the property tax. This specific tax is known as the industrial facility tax (IFT). Normally, the portion of these taxes due to a school district is paid

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instead to the school aid fund. However, if the IFT revenues are captured by a tax increment finance plan, the revenues flow to the TIF authority instead of the State.

Districts faced with the implementation of a Tax Increment Financing plan should contact the Michigan Department of Education, State Aid Section to assure that any taxable value adjustments are properly noted.

### **CAUTIONS**

If the amount of school taxes captured by a TIF exceeds the eligible obligations, refunds are to be made from the TIFAs to the school districts. These amounts must be reported to the Michigan Department of Education-State Aid Unit so that State aid can be recalculated.

School districts should be aware there are differences in the way that tax collecting treasurers handle the distribution of current and delinquent tax collections within their respective communities. The Michigan Department of Treasury has directed that local taxing units (including school districts) must be paid their levies in full before either current or delinquent taxes are distributed to a TIFA. When local units are paid their tax levies in full, the total of all subsequent delinquent tax collections and interest on taxes are to be paid to the TIFA treasurer.

Tax levy adjustments (board of review, tribunal, etc.) and charge backs are to be made in total against the payments made to the tax increment financing authority until those amounts equal the amount of taxes previously distributed to the tax increment financing authority. School districts concerned with the method of distribution used by their local or county treasurer may contact the Michigan Department of Treasury, Local Government Audit Division for guidance.

“Out of Formula” ISDs (ISDs not receiving section 56 or 62 State aid) should ensure they are receiving all Industrial and Commercial Facility taxes since it is possible the local unit treasurer may be remitting the ISD and IFT taxes to the State. It would be wise to notify all local unit treasurers that you are an “out of formula” ISD and as such are entitled to receive all IFT amounts.