Management Report

for

Metro Deaf School –
Minnesota North Star Academy
St. Paul, Minnesota
June 30, 2010

MMKR
CERTIFIED PUBLIC ACCOUNTANTS

PRINCIPALS
Kenneth W. Malloy, CPA
Thomas M. Montague, CPA
Thomas A. Karnowski, CPA
Paul A. Radosevich, CPA
William J. Lauer, CPA
James H. Eichten, CPA
Aaron J. Nielsen, CPA
Victoria L. Holinka, CPA

To the Board of Metro Deaf School – Minnesota North Star Academy
St. Paul, Minnesota

We have prepared this management report in conjunction with our audit of Metro Deaf School – Minnesota North Star Academy's (the School) financial statements for the year ended June 30, 2010. The purpose of this report is to make required communications to those who have responsibility for oversight of the financial reporting process and to provide comments resulting from our audit process. We have organized this report into the following sections:

- Audit Summary
- Basic Funding for Public Education in Minnesota
- Financial Trends of Your School
- Accounting and Auditing Updates
- Legislative Summary

We would be pleased to further discuss any of the information contained in this report or any other concerns that you would like us to address. We would also like to express our thanks for the courtesy and assistance extended to us during the course of our audit.

This report is intended solely for the information and use of those charged with governance, the Board, management, and those who have responsibility for oversight of the financial reporting process and is not intended to be, and should not be, used by anyone other than these specified parties.

Malloy, Montague, Karnowski, Radosevich & Co., P.A.

December 17, 2010

Malloy, Montague, Karnowski, Radosevich, & Co., P.A.
5353 Wayzata Boulevard • Suite 410 • Minneapolis, MN 55416 • Telephone: 952-545-0424 • Telefax: 952-545-0569 • www.mmkr.com

AUDIT SUMMARY

We hereby provide you with the following summary of our audit work, key conclusions, and other information that we consider important or that is required to be communicated to the Board, administration, or those charged with governance of the School.

OUR RESPONSIBILITY UNDER AUDITING STANDARDS GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA AND *GOVERNMENT AUDITING STANDARDS*

We have audited the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the School as of and for the year ended June 30, 2010. Professional standards require that we provide you with information about our responsibilities under auditing standards generally accepted in the United States of America and *Government Auditing Standards*; as well as certain information related to the planned scope and timing of our audit. We have communicated such information to you verbally and in our audit engagement letter. Professional standards also require that we communicate to you the following information related to our audit.

PLANNED SCOPE AND TIMING OF THE AUDIT

We performed the audit according to the planned scope and timing previously discussed and coordinated in order to obtain sufficient audit evidence and complete an effective audit.

AUDIT OPINION AND FINDINGS

Audit Opinion on the School's Financial Statements

We have issued an unqualified opinion on the School's financial statements. This means that after performing our audit tests and procedures, we have concluded that the basic financial statements fairly present the School's financial position and changes in financial position for the year ended June 30, 2010.

Report on Internal Controls and Compliance Over Financial Reporting

We reported no material weaknesses in the School's internal controls over financial reporting.

Our testing did not indicate any findings related to compliance over financial reporting that were required to be reported under *Government Auditing Standards*.

Report on Compliance With Minnesota Laws and Regulations

We have reported one finding based on our testing of the School's compliance with Minnesota laws and regulations. The School did not pay 10 of 25 invoices within 35 days of the receipt of goods or services, or the invoice for goods or services, as required by state statutes.

SIGNIFICANT ACCOUNTING POLICIES

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the School are described in Note 1 of the notes to basic financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the year.

We noted no transactions entered into by the School during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

ACCOUNTING ESTIMATES AND MANAGEMENT JUDGMENTS

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

> Special education state aid includes an adjustment related to tuition billings to and from other schools for special education services which are computed using formulas derived by the Minnesota Department of Education (MDE). Because of the timing of the calculations, this adjustment for fiscal 2010 is not finalized until after the School has closed its financial records for the fiscal period. The impact of this adjustment on the receivable and revenue recorded for state special education aid is calculated using preliminary information available to the School.
>
> The School uses estimates of useful lives for the depreciation of capital assets.

Management expects any differences between estimates and actual amounts of these estimates to be insignificant. We reviewed and tested management's procedures and underlying supporting documentation in the area discussed above. We concluded that the accounting estimates and management judgments appeared to consider all significant factors and resulted in appropriate accounting recognition.

AUDIT ADJUSTMENTS

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. For purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the School's financial reporting process (that is, cause future financial statements to be materially misstated). We did not propose any audit adjustments as a result of our audit.

DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT

We encountered no significant difficulties in dealing with management in performing and completing our audit.

DISAGREEMENTS WITH MANAGEMENT

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

MANAGEMENT CONSULTATIONS WITH OTHER INDEPENDENT ACCOUNTANTS

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the School's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

OTHER AUDIT FINDINGS OR ISSUES

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the School's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

MANAGEMENT REPRESENTATIONS

We have requested certain representations from management that are included in the management representation letter dated December 17, 2010.

BASIC FUNDING FOR PUBLIC EDUCATION IN MINNESOTA

Due to its complexity, it would be impossible to fully explain the funding of public education in Minnesota within this report. The last section of this report, which contains a summary of legislative changes affecting school districts, gives an indication of how complicated the funding system is. The following section provides some state-wide funding and financial trend information.

BASIC GENERAL EDUCATION REVENUE

The largest single funding source for Minnesota schools is basic general education aid. Each year, the Legislature sets a basic formula allowance. Total basic general education revenue is calculated by multiplying the formula allowance by the number of pupil units for which a school is entitled to aid.

The table below presents a historical summary of the basic formula allowance for general education aid:

School Year	Formula Allowance	Percent Increase
2000–2001	$ 3,964	6.0 %
2001–2002	$ 4,068	2.6 %
2002–2003	$ 4,601	13.1 %
2003–2004	$ 4,601	– %
2004–2005	$ 4,601	– %
2005–2006	$ 4,783	4.0 %
2006–2007	$ 4,974	4.0 %
2007–2008	$ 5,074	2.0 %
2008–2009	$ 5,124	1.0 %
2009–2010	$ 5,124	– %
2010–2011	$ 5,124	– %

The table above does not reflect temporary funding changes such as the $51 per pupil unit one-time additional general education aid school districts and charter schools received in 2008–2009, or the technology and operating capital aid received by school districts and charter schools in 2007–2008 ($40 per pupil unit) and 2008–2009 ($55 per pupil unit).

The table also does not reflect a one-time reduction to general education aid in 2009–2010 that was offset dollar-for-dollar by federal stimulus funds used by the state for fiscal stabilization.

The increase in the 2002–2003 fiscal year was unusually large because the State Legislature added $415 to the basic formula allowance to transfer a portion of school district operating referendum revenue from a property tax levy to a state aid. Since charter schools do not have levy authority, they received the benefit of this state aid increase with no offsetting levy reduction.

STATE GENERAL FUND BUDGET OUTLOOK

The state of Minnesota has experienced a series of major budget shortfalls and a steadily deteriorating financial condition in recent years. Local governments and other entities dependent on the state for funding have, in turn, had to deal with the resulting state aid cuts, holdbacks, and unallotments. For the fiscal year 2010–2011 biennium, the adopted state budget was balanced using several large accounting "shifts," one-time federal stabilization funds, and aid reductions. The accounting shifts, further explained in the Legislative Summary section of this report, include delaying state aid payments to school districts and charter schools, and accelerating the recognition of districts' tax levy revenue with an offsetting reduction in state aid. Both of these types of shifts typically do not reduce district or charter school revenues but significantly reduce their cash flow, forcing an increasing number to use short-term borrowing for daily cash flow needs. The state intends to pay these shifts back when it has the financial ability.

Current state budget projections for the fiscal year 2012–2013 biennium predict further significant shortfalls that will likely need to be addressed. Realistically, the state has already used up most of the accounting shifts available for this purpose, and additional federal assistance cannot be counted on. The recent election, which resulted in a new Governor and a number of new legislators, will have a substantial impact on how the state will address its budget predicament and the future direction of education funding. And, of course, the economy, while showing some signs of recovery, is unlikely to turn around quickly enough to solve the state's budget issues in the short-term. All of this adds up to a period of continued financial uncertainty for Minnesota school districts and charter schools.

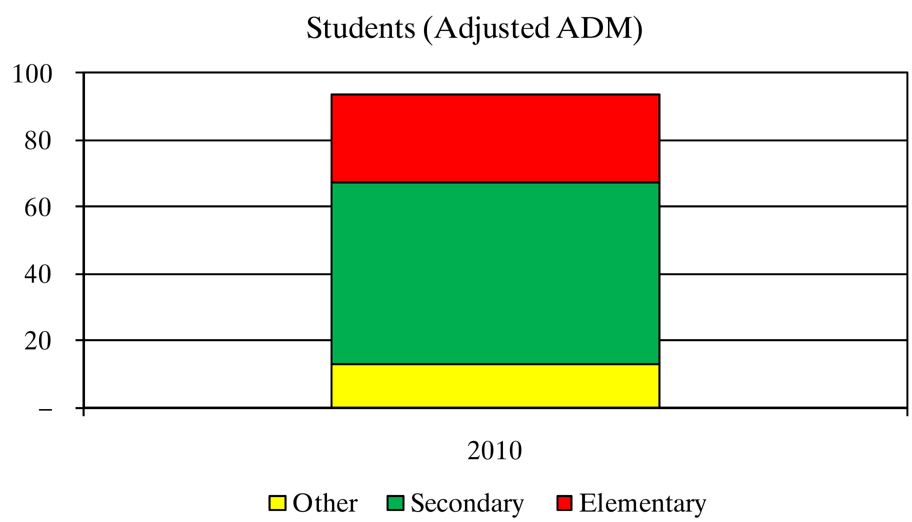
METERING OF STATE AID PAYMENTS

In order to help reduce the state budget deficit, the 2009 Legislature changed the metering of state aid payments to Minnesota school districts and charter schools beginning in 2009–2010. In past years, charter schools have been paid 90 percent of their estimated state aid entitlements by June 30 each year, with the remaining 10 percent paid out in the following fiscal year. In 2009–2010, the state paid only 73 percent of estimated state aid entitlements by year-end, with the remaining 27 percent to be paid out in the following fiscal year. This change did not affect the accrual based revenue recorded by charter schools for the year, but had a significant impact on their cash flow, greatly increasing the need for short-term cash flow borrowing among charter schools. The holdback will increase to 30 percent of estimated state aids in fiscal 2011.

FINANCIAL TRENDS OF YOUR SCHOOL

AVERAGE DAILY MEMBERSHIP (ADM) AND PUPIL UNITS

The following graph summarizes the ADM served by the School for the year:

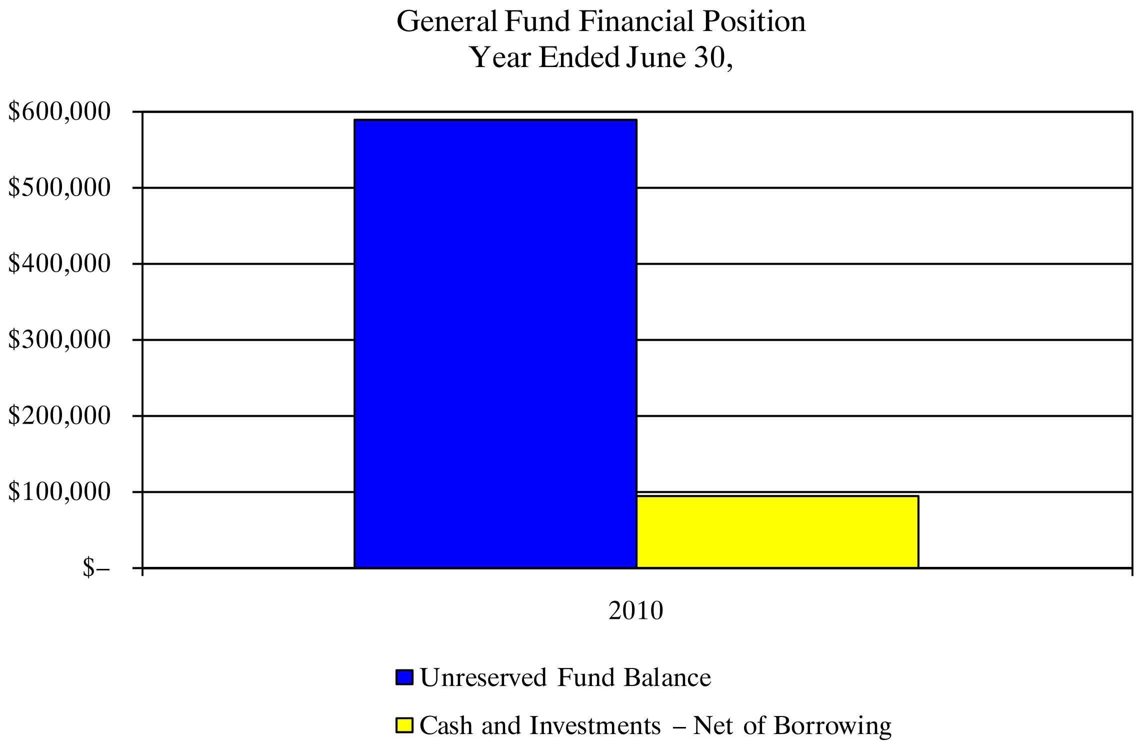


The School's ADM served for 2010 is estimated to be 94.

ADM is a measure of students attending class, which is converted to pupil units (the base for determining revenue) using a statutory formula. Not only is the original budget based on ADM estimates, the final audited financial statements are based on updated, but still estimated, ADM since the counts are not finalized until around January of the following year. When viewing revenue budget variances, one needs to consider these ADM changes and the impact of prior year final adjustments which affect the current year's revenue.

GENERAL FUND OPERATIONS AND FINANCIAL POSITION

The following graph displays the School's General Fund financial position for the year:

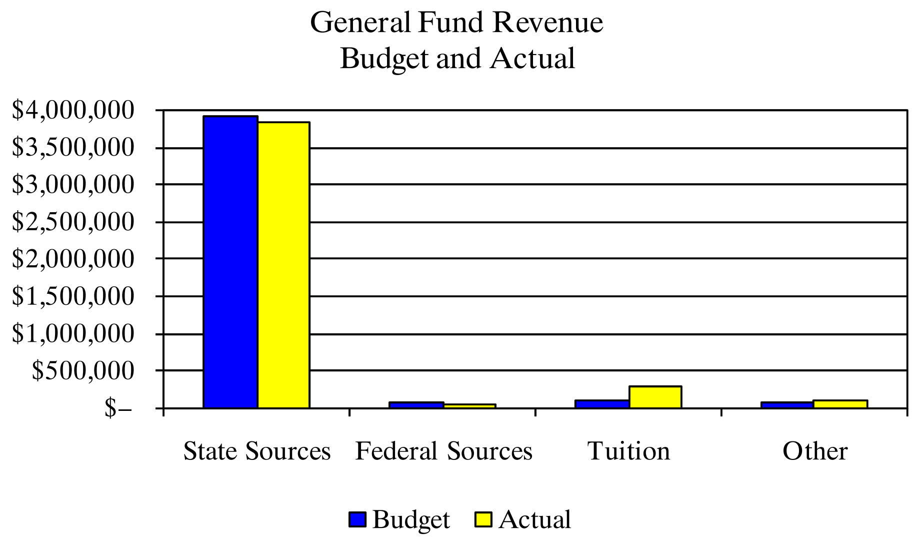


The School's General Fund ended 2010 with an unreserved fund balance of $588,664, an increase of $52,951 from the beginning of the year, and $56,804 higher than projected in the budget. The General Fund cash and investments balance at year-end, net of borrowing, was $93,499. The School's cash flow was greatly reduced due to the change in the metering of state aid payments discussed earlier.

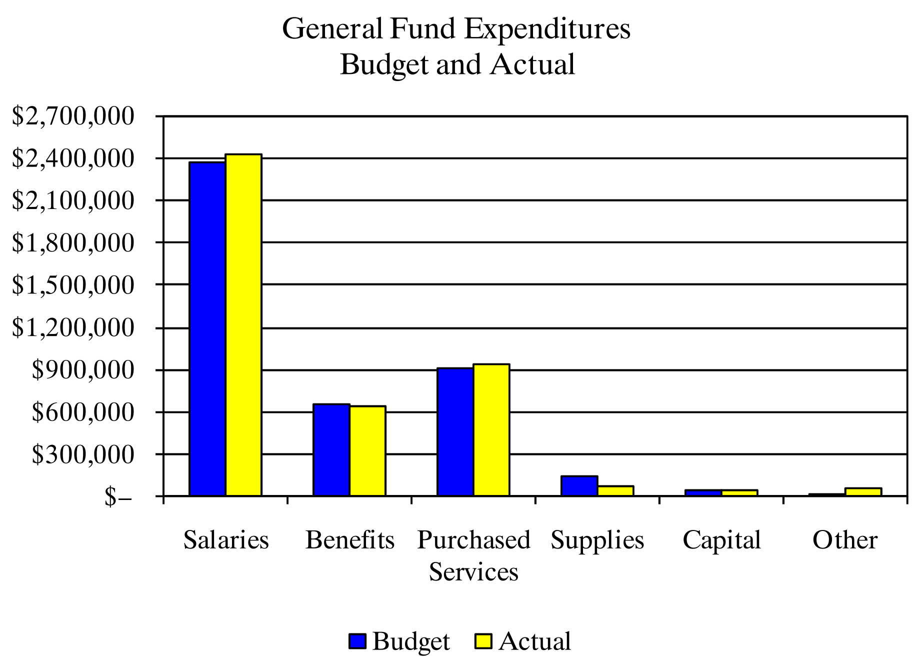
Unreserved fund balance as a percentage of expenditures is one key measure of school's financial health. The resources represented by this fund balance are critical to a school's ability to maintain adequate cash flow throughout the year, to retain its programs, and to cushion against the impact of unexpected costs or funding shortfalls. For the School, this ratio was 14.1 percent at the end of 2010.

GENERAL FUND REVENUE AND EXPENDITURES

The following graphs summarize the School's General Fund revenue and expenditures for 2010:



Total General Fund revenues for 2010 were $4,247,116, which was $110,517 over budget. Tuition was over budget by $192,173. The amounts to be billed to other Minnesota and Wisconsin districts were not known at the time the budget was approved; therefore, the School made a conservative estimate. State revenues were under budget by $83,038, mainly because the special education costs billed to other districts were higher than expected, reducing the costs that qualified for aid.



Total General Fund expenditures for 2010 were $4,188,481, which was $51,879 over budget. The budget variance was mainly due to higher personnel costs due to adding a teacher in the current year.

FOOD SERVICE SPECIAL REVENUE FUND

In 2010, the School's Food Service Special Revenue Fund expenditures exceeded revenues by $5,354, and the fund balance was $1,256 at year-end. The Food Service Special Revenue Fund was supported by the General Fund with a transfer in of $5,684. It is important that the Food Service Special Revenue Fund be self-sustaining, so it does not place an additional burden on the General Fund.

BUILDING COMPANY SPECIAL REVENUE FUND

The Building Company Special Revenue Fund is used to account for 1House2Hands, Inc. (the Building Company), which is considered to be a component unit of the School. The fund ended the year with a fund balance deficit of $76,412. This represents the amount that the cost of purchasing and renovating the School's new building exceeded the funding currently available for this purpose. The Building Company intends to eliminate this deficit in the future through increased rent and continued fundraising.

ENTITY-WIDE FINANCIAL STATEMENTS

The School's financial statements include fund-based information that focuses on budgetary compliance and sufficiency of the School's current assets to finance its current liabilities. The Governmental Accounting Standards Board (GASB) Statement No. 34 reporting model also requires the inclusion of two entity-wide financial statements designed to present a clear picture of the School as a single, unified entity. These entity-wide statements provide information on the total cost of delivering educational services, including capital assets and long-term liabilities.

Theoretically, net assets represent the resources the School has leftover to use for providing services after its debts are settled. However, those resources are not always in expendable form, or there may be restrictions on how the resources can be used. Therefore, the statement divides net assets into three components: net assets invested in capital assets, net of related debt; restricted net assets; and unrestricted net assets. The following table presents a summarized conversion of the School's governmental fund balances (as individually discussed earlier) to net assets and separate components for the year:

	June 30, 2010
Net assets – governmental activities	
Total fund balances – governmental funds	$ 513,508
Total capital assets, net of accumulated depreciation	4,359,372
Total long-term debt	(4,281,185)
Total net assets – governmental activities	$ 591,695
Net assets	
Invested in capital assets, net of related debt	$ 78,187
Restricted	1,256
Unrestricted	512,252
Total net assets	$ 591,695

Net assets increased $86,452 from the beginning of the year, mainly due to the improvement in the financial position of the General Fund.

ACCOUNTING AND AUDITING UPDATES

GASB STATEMENT NO. 54 – FUND BALANCE REPORTING AND GOVERNMENTAL FUND TYPE DEFINITIONS

The objective of this statement is to enhance the usefulness of fund balance information by providing clearer fund balance classifications that can be more consistently applied and by clarifying the existing governmental fund type definitions. This statement establishes fund balance classifications (nonspendable, restricted, committed, assigned, and unassigned) that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds. The definitions of the General Fund, special revenue, capital projects, debt service, and permanent fund types are clarified by the provisions in this statement. Elimination of the reserved component of fund balance in favor of a restricted classification will enhance the consistency between information reported in the government-wide statements and information in the governmental fund financial statements and avoid confusion about the relationship between reserved fund balance and restricted net assets. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2010.

GASB STATEMENT NO. 59 – FINANCIAL INSTRUMENTS OMNIBUS

The objective of this statement is to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. The requirements of this statement will improve financial reporting by providing more complete information, by improving consistency of measurements, and by providing clarifications of existing standards. Applying the reporting provisions of Statement No. 31 for interest-earning investment contracts to unallocated insurance contracts improves consistency of investment measurements that are reported by pension and other post-employment benefits (OPEB) plans. Emphasizing the applicability of SEC requirements to 2a7-like external investment pools provides practitioners with improved guidance. Limiting interest rate risk disclosures for investments in mutual funds, external investment pools, and other pooled investments to debt investment pools provides better guidance regarding the applicability of interest rate risk disclosures. Finally, addressing the applicability of Statement No. 53 to certain financial instruments refines which financial instruments are within the scope of that statement. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2010.

LEGISLATIVE SUMMARY

The following is a brief summary of current state of Minnesota legislative changes and issues affecting the funding of Minnesota charter schools. More detailed and extensive summaries are available from the MDE.

Basic General Education Revenue – The basic general education formula allowance for fiscal year (FY) 2010 and FY 2011 is $5,124, reflecting no increase from the FY 2009 level.

FY 2010 One-Time General Education Aid Reduction Offset by Federal Fiscal Stabilization Funds – Reduced the FY 2010 general education aid entitlement by $500 million. The reduction is allocated among school districts and charter schools. This one-time reduction is offset on a dollar-for-dollar basis by federal fiscal stabilization funds.

Alternative Teacher Compensation Revenue (Q Comp) – Clarification of change made reducing the basic Q Comp aid from 73.1 percent to 65 percent effective for FY 2010 and later. This results in a decrease in the basic aid, with a corresponding increase in the equalized levy revenue.

State Aid Payment Deferral – All state aids normally paid on a 90–10 schedule are changed to a 73–27 schedule for FY 2010 and 70–30 for FY 2011. The 90–10 schedule is reinstated for FY 2012; however, that is considered unlikely.

Accounting for Separation and Retirement Benefits – Clarifies accounting requirements for reserved and designated for separation and retirement benefits with the following:

- Designated for separation and retirement benefit account includes compensated absences, termination benefits, pension benefits, and OPEB not accounted for elsewhere.
- Designated account will no longer be limited to 50 percent of the amount necessary to meet obligations for the portion of severance pay that constitutes compensation for accumulated sick leave.
- MDE eliminated the reserve for severance account beginning with FY 2010 reporting.

PERA and TRA Rates – Contribution rates for employers and employees for the PERA Coordinated Plan increase by 0.25 percent effective January 1, 2011. Contribution rates for employers and employees for both the TRA Basic and Coordinated Plans increase by 0.5 percent each year through FY 2015. There is no additional aid to help fund these increases.

Minnesota Department of Education Budget – The MDE budget has been reduced by 3.8 percent for FY 2010 and 5.4 percent for FY 2011.

Statutory Operating Debt – Authorizes an advance final payment for school districts and charter schools in statutory operating debt. Sets the aid payment schedule at 90 percent of the aid entitlement for fiscal years 2010 and later.

Charter School Payment Modifications – Provides that the board of directors of any charter school serving fewer than 150 students where 100 percent of the students are eligible for special education services may request that MDE accelerate the school's cash flow.

Leased Property – Provides that property leased or rented to charter schools formed and operated under Minnesota Statutes, Section 124D.52 is exempt from taxation if the lease term is for a period of at least 12 months and is owned by (i) a nonprofit corporation; (ii) a public school district, college, or university; (iii) a private school, college, or university; (iv) a church; or (v) the state or a subdivision of the state. Similar to the language that exempts school districts from taxation for rented or leased property, the new language requires that the charter school use the property to provide direct instruction for K–12, special education or administrative services directly related to the educational program at that site. Finally, the lease must provide that the charter school has the exclusive right to use the property during the lease period.