



# MICHIGAN

OFFICE OF THE AUDITOR GENERAL

## AUDIT REPORT



THOMAS H. MCTAVISH, C.P.A.  
AUDITOR GENERAL

“...The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.”

– Article IV, Section 53 of the Michigan Constitution

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Michigan  
Office of the Auditor General  
**REPORT SUMMARY**

**Financial Audit**  
*Including the Provisions of the Single Audit Act*  
**Michigan Strategic Fund**  
*(A Component Unit of the State of Michigan)*  
*October 1, 2002 through September 30, 2004*

Report Number:  
64-800-05

Released:  
June 2005

*A Single Audit is designed to meet the needs of all financial report users, including an entity's federal grantor agencies. The audit determines if the financial schedules and/or financial statements are fairly presented; considers internal control over financial reporting and internal control over federal program compliance; determines compliance with State compliance requirements material to the financial schedules and/or financial statements; and assesses compliance with direct and material requirements of the major federal programs.*

**Financial Statements:**

**Auditor's Report Issued**

We issued an unqualified opinion on the Michigan Strategic Fund's (MSF's) financial statements.

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**Internal Control Over Financial Reporting**

We did not report any findings related to internal control over financial reporting.

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**Noncompliance or Other Matters Material to the Financial Statements**

We did not identify any instances of noncompliance or other matters applicable to the financial statements that are required to be reported under *Government Auditing Standards*.

~ ~ ~ ~ ~

**Federal Awards:**

**Auditor's Reports Issued on Compliance**

We audited one program as a major program and issued an unqualified opinion. The federal program audited as a major program is identified on the back of this summary.

~ ~ ~ ~ ~

**Internal Control Over Major Programs**

We did not identify any material weaknesses in internal control over major programs. However, we did identify a reportable condition (Finding 1).

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**Required Reporting of Noncompliance**

We identified an instance of noncompliance that is required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133 (Finding 1).

~ ~ ~ ~ ~

We audited the following program as a major program:

<u>CFDA Number</u>	<u>Program Title</u>	<u>Compliance Opinion</u>
14.228	Community Development Block Grants/State's Program	Unqualified

A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: <http://audgen.michigan.gov>



Michigan Office of the Auditor General  
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Lansing, Michigan 48913

**Thomas H. McTavish, C.P.A.**  
Auditor General

**Scott M. Strong, C.P.A., C.I.A.**  
Deputy Auditor General



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THOMAS H. MCTAVISH, C.P.A.  
AUDITOR GENERAL

June 30, 2005

Mr. David C. Hollister, President  
Michigan Strategic Fund  
300 North Washington Square  
Lansing, Michigan

Dear Mr. Hollister:

This is our report on the financial audit, including the provisions of the Single Audit Act, of the Michigan Strategic Fund (MSF) for the period October 1, 2002 through September 30, 2004.

This report contains our report summary; our independent auditor's report on the financial statements; the MSF management's discussion and analysis; and the MSF financial statements, notes to the financial statements, and schedule of expenditures of federal awards. This report also contains our independent auditor's report on internal control over financial reporting and on compliance and other matters, our independent auditor's report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with U.S. Office of Management and Budget Circular A-133, and our schedule of findings and questioned costs. In addition, the report contains MSF's summary schedule of prior audit findings, its corrective action plan, and a glossary of acronyms and terms.

Our finding and recommendation are contained in Section III of the schedule of findings and questioned costs. The agency preliminary response is contained in the corrective action plan. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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# INDEPENDENT AUDITOR'S REPORT



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THOMAS H. MCTAVISH, C.P.A.  
AUDITOR GENERAL

## Independent Auditor's Report on the Financial Statements

Mr. David C. Hollister, President  
Michigan Strategic Fund  
300 North Washington Square  
Lansing, Michigan

Dear Mr. Hollister:

We have audited the financial statements of the Michigan Strategic Fund, a component unit of the State of Michigan, as of and for the fiscal years ended September 30, 2004 and September 30, 2003, as identified in the table of contents. These financial statements are the responsibility of the Michigan Strategic Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial statements present only the Michigan Strategic Fund and do not purport to, and do not, present fairly the financial position of the State of Michigan or its component units as of September 30, 2004 and September 30, 2003 and the changes in financial position thereof for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Michigan Strategic Fund as of September 30, 2004 and September 30, 2003 and the changes in financial position for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis for the fiscal year ended September 30, 2004 on pages 11 through 15 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it. The management's discussion and analysis for the fiscal year ended September 30, 2003 was not presented because this information was presented with the Michigan Strategic Fund's prior year's audited financial statements.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 15, 2005 on our consideration of the Michigan Strategic Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of the internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the Michigan Strategic Fund's financial statements referred to in the first paragraph. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

AUDITOR GENERAL

March 15, 2005

# MANAGEMENT'S DISCUSSION AND ANALYSIS

This is a discussion and analysis of the financial performance of the Michigan Strategic Fund (MSF) for the fiscal year ended September 30, 2004. Act 270, P.A. 1984, created MSF. Executive Order No. 1999-1, effective April 5, 1999, transferred MSF to the Department of Management and Budget as an autonomous agency, governed by a nine-member Board of Directors. Executive Order No. 2003-18, effective December 7, 2003, transferred MSF as an autonomous agency to the Department of Labor and Economic Growth. MSF is a component unit of the financial reporting entity of the State of Michigan. MSF's management is responsible for the financial statements, notes to the financial statements, and this discussion.

### **Using the Financial Report**

This financial report is prepared in accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*.

- The reporting standards require a fund balance sheet; a statement of net assets; a statement of revenues, expenditures, and changes in fund balance; and a statement of activities.
- The reporting standards also require that special purpose governments provide both fund financial statements and government-wide financial statements. GASB Statement No. 34 also provides for combining these statements using a format that reconciles the two statements. Because this entity does not have any reconciling items, the statements are presented using one column for both presentations.

This financial report includes the reports of independent auditors, management's discussion and analysis, the basic financial statements, and the notes to the financial statements.

The financial statements are interrelated and represent the financial status of MSF. The fund balance sheet and statement of net assets are combined to present assets and liabilities as of the end of the fiscal year.

The fund statement of revenues, expenditures, and changes in fund balance is combined with the statement of activities to present the revenues earned and expenditures/expenses incurred during the fiscal year.

### **Analysis of Financial Activities**

The assets of MSF exceeded its liabilities by \$65,520 at September 30, 2004 and by \$56,500 at September 30, 2003. MSF's net assets primarily reflect cash on hand at the end of the fiscal year. MSF's total net assets increased by \$9,020 during fiscal year 2003-04.

### **Condensed Financial Information** **From the Fund Balance Sheet and Statement of Net Assets** **As of September 30**

	2004	2003
Amounts due from federal government	\$ 11,378,558	\$ 7,624,651
Cash and equity in common cash	824,054	481,994
Other current assets	13,034	6,370,067
Total Assets	<u>\$ 12,215,646</u>	<u>\$ 14,476,712</u>
Amounts due to MEDC	\$ 0	\$ 6,366,057
Other current liabilities	12,150,126	8,054,155
Total Liabilities	<u>\$ 12,150,126</u>	<u>\$ 14,420,212</u>
Total Fund Balance/Net Assets	<u>65,520</u>	<u>56,500</u>
Total Liabilities and Fund Balance/Net Assets	<u>\$ 12,215,646</u>	<u>\$ 14,476,712</u>

**Amounts due from federal government** primarily consist of receivables for federal pass-through funds for the Community Development Block Grants (CDBG) Program and correspond to **other current liabilities**, which primarily include amounts payable to the subgrantees from these federal pass-through funds. These line items increased significantly when compared to fiscal year 2002-03 because grant recipients submitted more requests for reimbursements near the end of fiscal year 2003-04 instead of submitting them consistently throughout the year as in the prior year.

**Other current assets** consist primarily of an 8% share of the net revenues collected from two Indian tribes, which is paid in accordance with the terms of the tribes' 1998 compact agreement with the State. This amount decreased significantly during fiscal year 2003-04, because the tribes contend that the Club Keno game, introduced by the

State Lottery, violated the terms of the compact agreement. The tribes placed payments for fiscal year 2003-04 into an escrow account rather than submitting them to MSF, pending the resolution of this matter. Based on information provided by the tribes, MSF estimated that the tribes placed approximately \$10.7 million into the escrow account relating to fiscal year 2003-04.

**Amounts due to MEDC** decreased significantly during fiscal year 2003-04 because MSF did not receive tribal gaming revenue as previously explained. Fiscal year 2002-03 reflects revenues (tribal gaming revenue, etc.) collected after the end of the fiscal year and transferred to the Michigan Economic Development Corporation (MEDC) in the following months in accordance with the terms of the interlocal agreement.

**Total fund balance/net assets** reflect primarily cash on hand as of the end of the fiscal year.

**Condensed Financial Information From the Fund Statement of Revenues,  
Expenditures, and Changes in Fund Balance and Statement of Activities**  
For the Fiscal Years Ended September 30

	2004	2003
Revenues		
Charges for services	\$ 1,337,539	\$ 1,565,028
Operating grants and contributions	35,988,802	37,670,845
Payments from the State of Michigan	47,986,911	85,081,586
Tribal gaming	2,070,053	13,262,232
Other	285,973	511,155
Total Revenues	\$ 87,669,277	\$ 138,090,846
Expenditures/Expenses		
CDBG	\$ 35,416,226	\$ 37,114,967
Payments to MEDC	51,507,094	100,227,016
Other	736,936	816,231
Total Expenditures/Expenses	\$ 87,660,257	\$ 138,158,215
Excess of Revenues Over Expenditures/Expenses/		
Change in Net Assets	\$ 9,020	\$ (67,369)
Fund Balance/Net Assets - Beginning	56,500	123,869
Fund Balance/Net Assets - Ending	\$ 65,520	\$ 56,500

**Charges for services** primarily consist of industrial development revenue bond (IDRB) issuance fees and application fees for the Michigan Economic Growth Authority (MEGA) and Brownfield. Using a portion of the federal allocation of tax-free bond issuance authority given to the State of Michigan, MSF can assist manufacturing businesses and nonprofit organizations raise funds for projects under \$10 million by issuing IDRBs. MSF receives fees for assisting with IDRB issuance. During fiscal year 2003-04, there was a decline in fees (charges for services) as a result of a reduced need of IDRB financing in the manufacturing sector because of a weak economy.

**Operating grants and contributions** decreased primarily because of a decrease in CDBG federal pass-through grant expenditures and corresponding federal revenue by the subgrantees. CDBG funds are disbursed to communities on a reimbursement basis

for infrastructure developments. Because of an overall weak economy during the audit period, the communities did not undertake infrastructure projects and, therefore, did not use the CDBG funds.

**Payments from the State of Michigan** primarily consist of the State's General Fund and Tobacco Settlement Trust Fund appropriations for MSF. Payments from the State of Michigan declined in fiscal year 2003-04 primarily because of a net reduction in the State appropriation from the State General Fund for administration and various other programs (\$14.6 million) and the Tobacco Settlement Trust Fund for the Life Sciences Program (\$22.5 million). This also accounts for reduced payments to MEDC in fiscal year 2003-04 when compared with fiscal year 2002-03.

**Tribal gaming** revenues were substantially lower in fiscal year 2003-04 as compared to fiscal year 2002-03 because two tribes placed the payments for fiscal year 2003-04 into an escrow account rather than submitting them to MSF. Based on information provided by the tribes, MSF estimated that the tribes placed approximately \$10.7 million into the escrow account relating to fiscal year 2003-04.

**Expenditures/Expenses** primarily consist of CDBG expenditures and payments to MEDC. Payments to MEDC decreased substantially because of a net reduction in State appropriations to fund programs administered by MEDC.

#### **Other Pertinent Information**

During fiscal year 1996-97 through fiscal year 2003-04, MSF disbursed \$40.9 million of CDBG federal funds for Industrial Park Loans/Grants to various local government entities. Per the agreement, local entities either could receive credits for creating a specific number of jobs or would need to return the funds to MSF. As of September 30, 2004, local entities received \$11.3 million in job credits and repaid \$5.3 million. In the event that no further jobs are created by these local entities, MSF may receive up to \$24.3 million in future years. These returned funds are treated as recaptured funds and, per federal regulation, are reused for other CDBG purposes.

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# FINANCIAL STATEMENTS

**MICHIGAN STRATEGIC FUND**  
Fund Balance Sheet and Statement of Net Assets  
As of September 30

	2004	2003
<b>ASSETS</b>		
Current Assets:		
Cash (Note 2)	\$ 50,000	\$ 50,000
Equity in common cash	774,054	431,994
Amounts due from federal government	11,378,558	7,624,651
Other current assets (Note 3)	13,034	6,370,067
Total Current Assets	\$ 12,215,646	\$ 14,476,712
Total Assets	\$ 12,215,646	\$ 14,476,712
<b>LIABILITIES</b>		
Current Liabilities:		
Accounts payable and other liabilities	\$ 11,890,977	\$ 7,882,524
Amounts due to MEDC		6,366,057
Amounts due to primary government	13,610	9,910
Deferred revenue	245,540	161,721
Total Current Liabilities	\$ 12,150,126	\$ 14,420,212
Total Liabilities	\$ 12,150,126	\$ 14,420,212
<b>FUND BALANCE/NET ASSETS</b>		
Unreserved fund balance/Unrestricted net assets	\$ 65,520	\$ 56,500
Total Fund Balance/Net Assets	\$ 65,520	\$ 56,500
Total Liabilities and Fund Balance/Net Assets	\$ 12,215,646	\$ 14,476,712

The accompanying notes are an integral part of the financial statements.

MICHIGAN STRATEGIC FUND

Fund Statement of Revenues, Expenditures, and Changes in Fund Balance  
and Statement of Activities  
For the Fiscal Year Ended September 30

	2004	2003
<b>REVENUES</b> (Note 1d)		
<u>Charges for Services</u>		
IDRB issuance fees	\$ 363,669	\$ 635,034
Other fees	973,870	929,994
<u>Operating Grants and Contributions</u>		
Community Development Block Grants (federal) (Note 5)	33,281,869	35,278,394
Community Development Block Grants (local and others) (Note 5)	2,047,192	1,615,228
Employment Service (federal)	659,741	777,224
<u>Payments From the State of Michigan</u>		
Payments from General Fund (Note 5)	37,986,911	52,581,586
Payments from Tobacco Settlement Trust Fund (Note 5)	10,000,000	32,500,000
<u>Other</u>		
Tribal gaming (Note 5)	2,070,053	13,262,232
Payment from MEDC	15,210	12,775
Miscellaneous	270,763	498,380
Total Revenues	\$ 87,669,277	\$ 138,090,846
 <b>EXPENDITURES/EXPENSES</b> (Note 1d)		
Administrative	\$ 509,760	\$ 565,682
Community Development Block Grants	35,416,226	37,114,967
Payments to MEDC	51,507,094	100,227,016
Payments to General Fund (indirect and refund)	227,176	250,549
Total Expenditures/Expenses	\$ 87,660,257	\$ 138,158,215
Excess of Revenues Over Expenditures/Expenses/ Change in Net Assets	\$ 9,020	\$ (67,369)
Fund Balance/Net Assets - Beginning	56,500	123,869
Fund Balance/Net Assets - Ending	\$ 65,520	\$ 56,500

The accompanying notes are an integral part of the financial statements.

## Notes to the Financial Statements

### Note 1 Significant Accounting Policies

The accounting policies of the Michigan Strategic Fund (MSF) conform to accounting principles generally accepted in the United States of America as applicable to governmental units. The following is a summary of the more significant policies:

#### a. Reporting Entity

MSF was created by Act 270, P.A. 1984, to help diversify the economy of the State and to provide for economic development, primarily by assisting business enterprises in obtaining additional sources of financing. Under the provisions of this Act, MSF succeeded to the rights, properties, obligations, and duties of the Michigan Job Development Authority and the Michigan Economic Development Authority.

Executive Order No. 1999-1 further authorized MSF to enter into an interlocal agreement with local public agencies. Under this authority, MSF created the Michigan Economic Development Corporation (MEDC) as a new public entity to help administer programs transferred to MSF. Any economic development programs transferred to MSF could be transferred, along with the relevant personnel and funding, to the new MEDC. MSF entered into an interlocal agreement with the Economic Development Corporation of the Charter County of Wayne, and MEDC was formed.

Under Executive Order No. 2003-18, effective December 7, 2003, MSF was transferred by type IV transfer from the Department of Management and Budget to the Department of Labor and Economic Growth. MSF remains an autonomous agency. The Executive Order also transferred the Board of Directors' position designated for the director of the Department of Management and Budget to the director of the Department of Labor and Economic Growth.

MSF is governed by a nine-member Board of Directors that consists of the director of the Department of Labor Economic and Growth, the State

Treasurer, and seven members appointed by the Governor with the advice and consent of the Senate.

MSF is a component unit of the financial reporting entity of the State of Michigan. The decision to include a potential component unit in the reporting entity is made by applying the criteria set forth in Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*. The basic criteria include the appointment of a voting majority of the governing board of MSF; the legal separation of the State and MSF; the fiscal independence of MSF; whether exclusion of the unit would make the *State of Michigan Comprehensive Annual Financial Report* misleading; and whether there is a potential for MSF to provide specific financial benefits to, or impose specific financial burdens on, the State.

b. Financial Statement Presentation

Under fund accounting, the accounts of the component units of the State of Michigan are organized on the basis of funds, each of which is considered a separate accounting entity. MSF's operations are accounted for in a separate set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenues, and expenditures. Government resources are allocated to and accounted for in separate funds, based upon the purposes for which they are to be spent and the means by which spending activities are controlled.

MSF is a governmental fund. The accompanying financial statements present only MSF. Accordingly, they do not purport to, and do not, present fairly the financial position and the changes in financial position of the State of Michigan or its component units in conformity with generally accepted accounting principles.

c. Measurement Focus and Basis of Accounting

The financial statements contained in this report are presented using the current financial resources measurement focus and the modified accrual basis of accounting, as provided by generally accepted accounting principles applicable to governments. Under the modified accrual basis of accounting, revenues are recognized as they become susceptible to

accrual, generally when they are both measurable and available. Revenues are considered to be available when they are collected within the current period or soon enough thereafter to pay liabilities of the current period. Expenditures generally are recorded when a liability is incurred; however, certain expenditures related to long-term obligations are recorded only when payment is due and payable.

GASB Statement No. 34 requires that special purpose governments provide both fund financial statements and government-wide financial statements. GASB Statement No. 34 also provides for combining these statements using a format that reconciles the individual line items of the fund level (modified accrual) to the government-wide level (full accrual). Because this entity does not have any reconciling items (such as long-term debt and capital assets), the statements are presented using one column with combined titles.

d. Financial Data

The MSF Board of Directors entered into an interlocal agreement with a local unit of government to create MEDC. MEDC came into existence on April 5, 1999. In accordance with the terms of the agreement, substantial assets, liabilities, and fund balances of MSF were transferred to MEDC on May 1, 1999. All revenues received from tribal gaming, industrial development revenue bond (IDRB) issuance fees, and other sources are transferred to MEDC on a monthly basis. This interlocal agreement also detailed all of MSF's State classified employees to MEDC. State appropriations available to MSF for this purpose are also made available to MEDC, as needed.

MSF financial statements primarily present the following:

- (1) Revenues: Amounts received from tribal gaming revenue, Community Development Block Grants (CDBG) from the U.S. Department of Housing and Urban Development, Employment Service grant from the U.S. Department of Labor, and other restricted revenues. Also included in revenues are the amounts available to MSF from State appropriations for fiscal years 2003-04 and 2002-03.

(2) Expenditures: CDBG pass-through grants and other minor administrative expenditures. Also included in expenditures are the funds transferred to MEDC during fiscal years 2003-04 and 2002-03 for the tribal gaming revenue, IDRB issuance fees, MEGA and Brownfield fees, and State appropriations to MSF. Expenditures for the Employment Service grant from the U.S. Department of Labor were recorded in MEDC's financial statements.

Note 2 Deposits and Investments

a. Deposits

Deposits reflected in MSF's bank accounts (without recognition of outstanding checks or deposits in transit) at September 30, 2004 and at September 30, 2003 were \$50,000, which was covered by federal depository insurance and was classified in GASB credit risk category 1.

b. Investments

No investment activities occurred during either fiscal year.

Note 3 Other Current Assets

MSF's other current assets totaled \$13,034 at September 30, 2004 (\$6,370,067 at September 30, 2003). These balances consisted of:

	As of September 30	
	2004	2003
Other Current Assets:		
Tribal gaming revenue	\$ 0	\$ 6,366,057
Miscellaneous	13,034	4,010
Total Other Current Assets	<u>\$ 13,034</u>	<u>\$ 6,370,067</u>

Other current assets consist primarily of an 8% share of the net revenues collected from two Indian tribes, which is paid in accordance with the terms of the tribes' 1998 compact agreement with the State. As explained in Note 6, MSF's 8% share of these revenues decreased significantly during fiscal year 2003-04.

Note 4 Bond Programs

MSF and a predecessor entity (the Michigan Job Development Authority) issued IDRBs. In addition, MSF issued bonds under its Taxable Bond Program. The bonds issued are payable solely from the net revenues of the project and are not an obligation of MSF or the State of Michigan. After the bonds are issued, all financial activities are assumed by a trustee, depository, or paying agent. Accordingly, these obligations are not reported in the MSF financial statements. Information regarding the status of such bond issues must be obtained from the trustee or depository for bonds, the industrial or commercial enterprise benefited by the bonds, or some other knowledgeable source.

The total amount of IDRBs issued by MSF and its predecessor entity for the period January 1, 1979 through September 30, 2004 was \$6,767,368,339 (\$6,510,273,339 through September 30, 2003). The total amount of bonds issued by MSF under the Taxable Bond Program for the period October 1, 2003 through September 30, 2004 was \$955,000 (\$205,000 for the period October 1, 2002 through September 30, 2003).

Note 5 Major Revenue Sources

The implementation of GASB Statement No. 34 requires that amounts received from State appropriations be treated as direct revenue. MSF recorded \$37,986,911 (\$52,581,586 in fiscal year 2002-03) and \$10,000,000 (\$32,500,000 in fiscal year 2002-03) received from the State General Fund and Tobacco Settlement Trust Fund appropriations, respectively, as revenues in fiscal year 2003-04.

MSF recorded \$35,329,061 (\$36,893,621 in fiscal year 2002-03) in revenue during fiscal year 2003-04 for the CDBG Program. This amount represented approximately 89.0% (69.6% for the fiscal year ended September 30, 2003) of total revenues (excluding funding from State appropriations) for the fiscal year ended September 30, 2004.

Another revenue source for MSF is its 8% share of the net revenues derived from the class III electronic games of chance of two casinos located in Michigan. During the fiscal year ended September 30, 2004, revenue was recognized from this source in the amount of \$2,070,053 (\$13,262,232 during

the fiscal year ended September 30, 2003). This amount represented approximately 5.2% (25.0% for the fiscal year ended September 30, 2003) of total revenues (excluding funding from State appropriations) for the fiscal year ended September 30, 2004. As explained in Note 6, MSF's 8% share of these revenues decreased significantly during fiscal year 2003-04.

Note 6 Contingencies - Tribal Gaming Revenues

MSF had been receiving an 8% share of the net revenues collected from two Indian tribes, which was paid in accordance with the terms of the tribes' 1998 compact agreement with the State. This amount decreased significantly during fiscal year 2003-04 because the tribes contend that the Club Keno game, introduced by the State Lottery, violated the terms of the compact agreement. The tribes placed the payments for fiscal year 2003-04 into an escrow account rather than submitting them to MSF. Based on information provided by the tribes, MSF estimated that the tribes placed approximately \$10.7 million into the escrow account relating to fiscal year 2003-04. The State and MSF are working with the two Indian tribes to resolve this matter.

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SUPPLEMENTAL  
FINANCIAL SCHEDULE

MICHIGAN STRATEGIC FUND  
Schedule of Expenditures of Federal Awards (1)  
For the Period October 1, 2002 through September 30, 2004

Federal Agency/Program	CFDA (2) Program Number	Pass-Through Identification Number	For the Fiscal Year Ended September 30, 2003		
			Directly Expended	Distributed to Subrecipients	Total Expended and Distributed
<b><u>U.S. Department of Housing and Urban Development</u></b>					
Direct Program:					
Community Development Block Grants/State's Program (3) (4)	14.228		\$ 1,638,384	\$ 35,145,291	\$ 36,783,675
<b>Total U.S. Department of Housing and Urban Development</b>			<b>\$ 1,638,384</b>	<b>\$ 35,145,291</b>	<b>\$ 36,783,675</b>
<b><u>U.S. Department of Labor</u></b>					
Pass-Through Program:					
Michigan Department of Labor and Economic Growth Employment Service	17.207	205-Y01		\$ 777,224	\$ 777,224
<b>Total U.S. Department of Labor</b>				<b>\$ 777,224</b>	<b>\$ 777,224</b>
Total Expenditures of Federal Awards			<b>\$ 1,638,384</b>	<b>\$ 35,922,515</b>	<b>\$ 37,560,899</b>

- (1) Basis of Presentation: This schedule includes the federal grant activity of the Michigan Strategic Fund and is presented on the modified accrual basis of accounting. This information is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts may differ from amounts presented in, or used in the preparation of, the financial statements.
- (2) CFDA is defined as *Catalog of Federal Domestic Assistance*.
- (3) Program income increases the federal award; federal regulations allow for the entity to retain and spend program income according to the federal guidelines.
- (4) CFDA 14.228 has open grants from program years 1998 through 2004.

For the Fiscal Year Ended September 30, 2004

<u>Directly Expended</u>	<u>Distributed to Subrecipients</u>	<u>Total Expended and Distributed</u>	<u>Total Expended and Distributed for the Two-Year Period</u>
<u>\$ 1,711,350</u>	<u>\$ 33,082,351</u>	<u>\$ 34,793,701</u>	<u>\$ 71,577,376</u>
<u><b>\$ 1,711,350</b></u>	<u><b>\$ 33,082,351</b></u>	<u><b>\$ 34,793,701</b></u>	<u><b>\$ 71,577,376</b></u>
<u>\$</u>	<u>\$ 659,741</u>	<u>\$ 659,741</u>	<u>\$ 1,436,965</u>
<u>\$ 0</u>	<u>\$ 659,741</u>	<u>\$ 659,741</u>	<u>\$ 1,436,965</u>
<u><b>\$ 1,711,350</b></u>	<u><b>\$ 33,742,092</b></u>	<u><b>\$ 35,453,442</b></u>	<u><b>\$ 73,014,341</b></u>

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INDEPENDENT AUDITOR'S REPORTS ON  
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN  
OFFICE OF THE AUDITOR GENERAL  
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LANSING, MICHIGAN 48913  
(517) 334-8050  
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THOMAS H. MCTAVISH, C.P.A.  
AUDITOR GENERAL

## Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters

Mr. David C. Hollister, President  
Michigan Strategic Fund  
300 North Washington Square  
Lansing, Michigan

Dear Mr. Hollister:

We have audited the financial statements of the Michigan Strategic Fund, a component unit of the State of Michigan, as of and for the fiscal years ended September 30, 2004 and September 30, 2003, as identified in the table of contents, and have issued our report thereon dated March 15, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

### Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Michigan Strategic Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

### Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Michigan Strategic Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Michigan Strategic Fund's Board of Directors and management, the Legislature, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL

March 15, 2005



STATE OF MICHIGAN  
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THOMAS H. MCTAVISH, C.P.A.  
AUDITOR GENERAL

Independent Auditor's Report on Compliance With  
Requirements Applicable to Each Major Program  
and on Internal Control Over Compliance in  
Accordance With OMB Circular A-133

Mr. David C. Hollister, President  
Michigan Strategic Fund  
300 North Washington Square  
Lansing, Michigan

Dear Mr. Hollister:

Compliance

We have audited the compliance of the Michigan Strategic Fund, a component unit of the State of Michigan, with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to each major federal program for the two-year period ended September 30, 2004. The Michigan Strategic Fund's major federal program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each major federal program is the responsibility of the Michigan Strategic Fund's management. Our responsibility is to express an opinion on the Michigan Strategic Fund's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to in the previous paragraph that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Michigan Strategic Fund's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Michigan Strategic Fund's compliance with those requirements.

In our opinion, the Michigan Strategic Fund complied, in all material respects, with the requirements referred to in the first paragraph that are applicable to each major federal program for the two-year period ended September 30, 2004. However, the results of our

auditing procedures disclosed an instance of noncompliance with those requirements, which is required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying schedule of findings and questioned costs as Finding 1.

#### Internal Control Over Compliance

The management of the Michigan Strategic Fund is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Michigan Strategic Fund's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted a matter involving the internal control over compliance and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the Michigan Strategic Fund's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. The reportable condition is described in the accompanying schedule of findings and questioned costs as Finding 1.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition identified in the previous paragraph is not a material weakness.

This report is intended solely for the information and use of the Michigan Strategic Fund's Board of Directors and management, the Legislature, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL

March 15, 2005

# SCHEDULE OF FINDINGS AND QUESTIONED COSTS

## Section I: Summary of Auditor's Results

### Financial Statements

Type of auditor's report issued:	Unqualified*
Internal control* over financial reporting:	
Material weaknesses* identified?	No
Reportable conditions* identified that are not considered to be material weaknesses?	None reported
Noncompliance or other matters material to the financial statements?	No

### Federal Awards

Internal control over major programs:	
Material weaknesses identified?	No
Reportable condition identified that is not considered to be a material weakness?	Yes
Type of auditor's report issued on compliance for major programs:	Unqualified
Any audit findings disclosed that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133, Section 510(a)?	Yes

Identification of major program:

<u>CFDA Number</u>	<u>Name of Federal Program</u>
14.228	Community Development Block Grants/State's Program

Dollar threshold used to distinguish between type A and type B programs:	\$2,190,430
Auditee qualified as a low-risk auditee*?	No

\* See glossary at end of report for definition.

## Section II: Findings Related to the Financial Statements

We did not report any findings related to the financial statements.

## Section III: Findings and Questioned Costs\* Related to Federal Awards

### **FINDING (64S0501)**

#### 1. Subrecipient\* Monitoring

U.S. Department of Housing and Urban Development	CFDA 14.228: Community Development Block Grants/State's Program
Award Number: B-99-DC-26-0001 B-00-DC-26-0001 B-01-DC-26-0001 B-02-DC-26-0001 B-03-DC-26-0001 B-04-DC-26-0001	Award Period: 01/01/1999 - Depletion 01/01/2000 - Depletion 01/01/2001 - Depletion 01/01/2002 - Depletion 01/01/2003 - Depletion 01/01/2004 - Depletion
	Questioned Costs: \$0

The Michigan Strategic Fund's (MSF's) internal control over the Community Development Block Grants (CDBG) Program did not ensure compliance with federal laws and regulations relating to subrecipient monitoring.

Internal control that does not ensure compliance with federal laws and regulations could result in sanctions, disallowances, and/or future reductions of CDBG Program awards.

MSF distributed \$68.2 million to 150 CDBG Program subrecipients during fiscal years 2003-04 and 2002-03, including \$20.9 million that was distributed to a single subrecipient.

\* See glossary at end of report for definition.

The federal Single Audit Act and OMB Circular A-133 require MSF to monitor the activities of its subrecipients to ensure that its subrecipients use federal funds in compliance with applicable laws and regulations and provisions of contracts or grants.

Subrecipient monitoring can be accomplished through various methods, including performing site visits, obtaining and reviewing Single Audits\* or limited scope audits of subrecipients, obtaining and reviewing other reports submitted by the subrecipient, or reviewing documentation that supports requests for reimbursement.

MSF had established subrecipient monitoring procedures for most of its smaller subrecipients, including performing site visits and reviewing Single Audit reports, six-month progress reports, and reimbursement requests.

MSF informed us that, for its largest CDBG Program subrecipient, it had relied solely on the Single Audits of that subrecipient for its subrecipient monitoring responsibilities. However, our review disclosed that the Single Audits of this subrecipient did not always include audit coverage of the CDBG Program funds that had been provided by MSF. As a result, because MSF had not performed sufficient other subrecipient monitoring procedures, MSF could not ensure that this CDBG Program subrecipient had expended these funds in compliance with laws, regulations, and provisions of contracts or grants applicable to the CDBG Program.

## **RECOMMENDATION**

We recommend that MSF improve internal control over the CDBG Program to ensure compliance with federal laws and regulations relating to subrecipient monitoring.

**The status of the findings related to federal awards that were reported in prior Single Audits is disclosed in the summary schedule of prior audit findings.**

\* See glossary at end of report for definition.

## OTHER SCHEDULES

MICHIGAN STRATEGIC FUND  
Summary Schedule of Prior Audit Findings  
As of September 30, 2004

**PRIOR AUDIT FINDINGS RELATED TO THE FINANCIAL STATEMENTS**

There were no findings related to the financial statements in the prior Single Audit.

**PRIOR AUDIT FINDINGS RELATED TO FEDERAL AWARDS**

Audit Findings That Have Been Fully Corrected:

**Audit Period:** October 1, 2000 through September 30, 2002

**Finding Number:** 07S0301

**Finding Title:** Payroll Distributions

**Finding:** The Michigan Strategic Fund (MSF) did not establish controls to ensure compliance with federal requirements related to payroll charged to the Community Development Block Grants (CDBG) Program.

**Comments:** MSF has established controls to ensure compliance with federal requirements related to payroll charged to the CDBG Program.

MICHIGAN STRATEGIC FUND

Corrective Action Plan

As of June 14, 2005

**FINDINGS RELATED TO THE FINANCIAL STATEMENTS**

There were no findings related to the financial statements for fiscal years 2002-03 and 2003-04.

**FINDINGS RELATED TO FEDERAL AWARDS**

**Finding Number:** 64S0501  
**Finding Title:** Subrecipient Monitoring  
**Management Views:** We agree.

The subrecipient in question is the Michigan State Housing Development Authority (MSHDA), a State of Michigan agency. Per a memorandum of understanding between the Michigan Strategic Fund (MSF) and MSHDA, MSHDA is to ensure that its annual audit includes compliance testing of Community Development Block Grants (CDBG) funds. MSF has relied on the results of this compliance testing as part of its subrecipient monitoring procedures. However, during the audit of MSHDA for the fiscal year ended June 30, 2003, compliance testing for CDBG funds was not performed. MSHDA has acknowledged the oversight and has agreed to ensure that compliance testing of CDBG funds will be completed in all future audits.

The U.S. Department of Housing and Urban Development (HUD) has also made a determination that MSHDA is not considered a subrecipient, but a

State agency helping MSF distribute the CDBG funds for housing. However, the Office of the Auditor General has concluded that HUD's determination was not in compliance with the provisions of U.S. Office of Management and Budget (OMB) Circular A-133.

**Corrective Action:**

MSF is in the process of establishing formal subrecipient monitoring procedures to ensure that MSHDA complies with applicable laws, regulations, and provisions of contracts or grants funded by the CDBG Program, regardless of annual audit activity.

**Anticipated Completion Date:** December 2005

**Responsible Individual:** Doug Voshell, Managing Director of the CDBG Program

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# GLOSSARY

## Glossary of Acronyms and Terms

CDBG	Community Development Block Grants.
<i>CFDA</i>	<i>Catalog of Federal Domestic Assistance.</i>
financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are fairly presented in conformity with the disclosed basis of accounting.
GASB	Governmental Accounting Standards Board.
HUD	U.S. Department of Housing and Urban Development.
IDRB	industrial development revenue bond.
internal control	A process, effected by management, designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
low-risk auditee	As provided for in OMB Circular A-133, an auditee that may qualify for reduced federal audit coverage if it receives an annual Single Audit and it meets other criteria related to prior audit results. In accordance with State statute, this Single Audit was conducted on a biennial basis; consequently, this auditee is not considered a low-risk auditee.
material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.

material noncompliance	Violations of laws and regulations that could have a direct and material effect on major federal programs or on financial schedule and/or financial statement amounts.
material weakness	A reportable condition related to the design or operation of internal control that does not reduce to a relatively low level the risk that either misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and/or financial statements or noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
MEDC	Michigan Economic Development Corporation.
MEGA	Michigan Economic Growth Authority.
MSF	Michigan Strategic Fund.
MSHDA	Michigan State Housing Development Authority.
OMB	U.S. Office of Management and Budget.
questioned cost	A cost that is questioned by the auditor because of an audit finding: (1) which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds; (2) where the costs, at the time of the audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

reportable condition	A matter coming to the auditor's attention relating to a significant deficiency in the design or operation of internal control that, in the auditor's judgment, could adversely affect the entity's ability to (1) initiate, record, process, and report financial data consistent with the assertions of management in the financial schedules and/or financial statements or (2) administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.
Single Audit	A financial audit, performed in accordance with the Single Audit Act Amendments of 1996, that is designed to meet the needs of all federal grantor agencies and other financial report users. In addition to performing the audit in accordance with the requirements of auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in <i>Government Auditing Standards</i> issued by the Comptroller General of the United States, a Single Audit requires the assessment of compliance with requirements that could have a direct and material effect on a major federal program and the consideration of internal control over compliance in accordance with OMB Circular A-133.
subrecipient	A nonfederal entity that expends federal awards received from another nonfederal entity to carry out a federal program.
unqualified opinion	An auditor's opinion in which the auditor states that: <ul style="list-style-type: none"> <li>a. The financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting; or</li> <li>b. The financial schedules and/or financial statements presenting supplemental financial information are fairly</li> </ul>

stated in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules taken by themselves; or

- c. The audited agency complied, in all material respects, with the cited requirements that are applicable to each major federal program.

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