FINANCIAL AUDIT

OF THE

MICHIGAN STRATEGIC FUND

October 1, 2000 through September 30, 2001

07-401-02

Michigan
Office of the Auditor General
REPORT SUMMARY

Financial Audit

Michigan Strategic Fund

Fiscal Year Ended September 30, 2001

Report Number:
07-401-02

Released:
June 2002

A financial audit determines if the financial statements are fairly presented; considers internal control over financial reporting; and determines compliance with State compliance requirements material to the financial statements. This financial audit of the Michigan Strategic Fund (MSF) was conducted as part of the constitutional responsibility of the Office of the Auditor General.

Financial Statements:

Auditor's Report Issued

We issued an unqualified opinion on MSF's financial statements.

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Internal Control Over Financial Reporting

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

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Noncompliance Material to the Financial Statements

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

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Background:

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. Executive Order No. 1999-1, in conjunction with an interlocal agreement, transferred substantial assets, liabilities, and fund balances of MSF to the Michigan Economic Development Corporation (MEDC). This Executive Order and interlocal agreement also transferred funding and detailed MSF's State classified employees to MEDC.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: www.state.mi.us/audgen/

Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

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

June 27, 2002

Mr. Doug Rothwell, President
Michigan Strategic Fund
300 North Washington Square
Lansing, Michigan

Dear Mr. Rothwell:

This is our report on the financial audit of the Michigan Strategic Fund for the period October 1, 2000 through September 30, 2001.

This report contains our report summary, our independent auditor's report on the financial statements, management's discussion and analysis, and the Michigan Strategic Fund financial statements and notes to the financial statements. This report also contains our independent auditor's report on compliance and on internal control over financial reporting; a finding, recommendation, and entity preliminary response; and a glossary of acronyms and terms.

The entity's preliminary response was taken from the entity's response subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited entity 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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INTRODUCTION

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

Independent Auditor's Report on
the Financial Statements

February 15, 2002

Mr. Doug Rothwell, President
Michigan Strategic Fund
300 N. Washington Square
Lansing, Michigan

Dear Mr. Rothwell:

We have audited the accompanying statement of net assets and fund balance sheet of the Michigan Strategic Fund, a component unit of the State of Michigan, as of September 30, 2001 and September 30, 2000 and the related statement of activities and fund statement of revenues, expenditures, and changes in fund balance for the fiscal years then ended. 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 1b, the accompanying financial statements present only the Michigan Strategic Fund and are not intended to present fairly the financial position and results of operations of the State of Michigan or its component units.

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, 2001 and September 30, 2000 and the results of its operations for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Notes 1c and 7 to the financial statements, the Michigan Strategic Fund adopted Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*; Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*; and Statement No. 38, *Certain Financial Statement Note Disclosures*.

The management's discussion and analysis 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 supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated February 15, 2002 on our tests of the Michigan Strategic Fund's compliance with certain provisions of laws, regulations, contracts, and grants and on our consideration of its internal control over financial reporting. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

AUDITOR GENERAL

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, 2001. 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. MSF is a component unit of the financial reporting entity of the State of Michigan. MSF's management is responsible for the financial statements, footnotes, and this discussion.

Using the Financial Report

In June 1999, the Governmental Accounting Standards Board (GASB) released Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*.

- The new reporting standards require a statement of net assets; a statement of activities; and a statement of revenues, expenditures, and changes in fund balances.

- The fiscal year 2000-01 financial statements differ in form compared with prior years' financial statements. The fiscal year 1999-2000 statements have been restated to comply with GASB Statement No. 34.

- The new reporting standards 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 report of independent auditors, management's discussion and analysis, the basic financial statements in the new format, and the notes to the financial statements.

The financial statements are interrelated and represent the financial status of MSF. As previously noted, the balance sheet is combined with the statement of net assets, which includes assets and liabilities.

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

Analysis of Financial Activities

The primary source of revenue for MSF is legislative appropriation from the State of Michigan. MSF also collects an 8% share of the net revenues from several casinos operated by Native American tribes. A 9-member board of directors governs MSF.

Except for the administrative cost of classified employees detailed to the Michigan Economic Development Corporation (MEDC) and federal Community Development Block Grant (CDBG) funding, all funds received by MSF from the State of Michigan are used at the discretion of the MEDC Executive Committee within the legislative intent of the appropriations act.

Condensed Financial Information
From the Statement of Net Assets
As of September 30

	2001	2000
Amounts due from federal government	$ 7,299,243	$ 11,880,759
Other current assets	5,507,957	8,436,056
Total Assets	$ 12,807,200	$ 20,316,815
Amount due to MEDC (gaming revenues, etc.)	$ 5,298,031	$ 8,299,785
Other current liabilities	7,333,003	11,937,798
Total Liabilities	$ 12,631,034	$ 20,237,583
Net assets	176,166	79,232
Total Liabilities and Net Assets	$ 12,807,200	$ 20,316,815

Amounts due from federal government were reduced at the end of fiscal year 2000-01 because federal funds were collected in a timely fashion for the cash draw requests made by the subgrantee for federal pass-through funds. This also accounts for the reduction in **other current liabilities**, which primarily include amounts payable to the subgrantees from the federal pass-through funds.

Other current assets primarily include gaming revenues receivable. During November 2001, the U.S. Court of Appeals for the Sixth Circuit rendered a judgment releasing all casinos from their obligation under the 1993 compact to make payments to MSF. As a result of this judgment, a $3.6 million gaming revenue receivable recorded in fiscal year 1998-99 was written off.

Amount due to MEDC reflects revenues collected at the end of the fiscal year and transferred to MEDC in the following month in accordance with the terms of the interlocal agreement.

Net assets reflect primarily cash on hand at the end of the fiscal year.

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

	2001	2000
Revenues		
Charges for services	$ 1,613,066	$ 1,113,030
Operating grants and contributions	41,194,671	54,617,786
Payments from State of Michigan	115,316,338	165,333,314
Other	13,495,327	8,946,005
Total Revenues	$ 171,619,402	$ 230,010,135
Expenditures		
CDBG	$ 40,663,095	$ 55,045,958
Payments to MEDC	126,880,019	174,941,176
Other	3,979,354	2,686
Total Expenditures	$ 171,522,468	$ 229,989,820
Excess of Revenues Over Expenditures/ Change in Net Assets	$ 96,934	$ 20,315
Fund Balance/Net Assets - Beginning	79,232	58,917
Fund Balance/Net Assets - Ending	$ 176,166	$ 79,232

Charges for services primarily consist of industrial development revenue bond (IDRB) fees and application fees for Brownfield and the Michigan Economic Growth Authority

(MEGA). The increase in charges for services revenue during fiscal year 2000-01 reflects increased activities for Brownfield and MEGA.

Operating grants and contributions declined primarily because of a reduction of CDBG federal pass-through grant expenditures and corresponding federal revenue by the subgrantees.

Payments from the State of Michigan 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 2000-01 primarily because of a one-time State appropriation of $50 million for the Michigan Core Community Fund included in fiscal year 1999-2000. This also accounts for reduced **payments to MEDC** in fiscal year 2000-01 when compared with fiscal year 1999-2000.

The opening of new tribal casinos and the licensure of casinos in Detroit pursuant to an initiative approved by Michigan voters in 1996 ended the obligation of seven tribes to make payments to MSF. Under a federal court agreement with the State, five tribes ceased making payments in June 1999. Two casinos stopped remitting required payments after February 19, 1999. In November 2001, the U.S. Court of Appeals for the Sixth Circuit upheld the judgment from a lower court releasing all seven tribes from their obligation under the 1993 compact to make payments to MSF. No further appeal is planned at this point. Considering no plans for further appeal by the MSF Board of Directors, $3.6 million was written off for the gaming revenue receivable for the period February through June 1999 from two casinos that stopped making payments in February 1999.

To reflect the accounting impact of this judgment, a bad debt **expenditure (other)** of $3.6 million has been recorded for the amount not collectible from the casinos, as well as **other revenue** of $3.6 million to write off the amount previously recorded as an account payable to MEDC.

Other Pertinent Information

The opening of two more casinos covered by a 1998 compact is expected in fiscal years 2002-03 and 2003-04 and may increase gaming revenues. The opening date of these casinos and the estimated revenues are not certain.

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

	2001	2000 (RESTATED)
ASSETS		
Current Assets:		
Cash (Note 2)	$ 60,250	$ 79,163
Equity in Common Cash	133,844	
Amounts due from federal government	7,299,243	11,880,759
Amounts due from local units	2,000	
Other current assets	5,311,863	8,356,893
Total Current Assets	$ 12,807,200	$ 20,316,815
Total Assets	$ 12,807,200	$ 20,316,815
LIABILITIES		
Current Liabilities:		
Accounts payable and other liabilities	$ 7,329,427	$ 11,927,321
Amounts due to component units	5,298,031	8,299,785
Amounts due to primary government	3,576	4,930
Deferred revenue		5,547
Total Current Liabilities	$ 12,631,034	$ 20,237,583
Total Liabilities	$ 12,631,034	$ 20,237,583
FUND BALANCE/NET ASSETS		
Unreserved fund balance/Unrestricted net assets	$ 176,166	$ 79,232
Total Fund Balance/Net Assets	$ 176,166	$ 79,232
Total Liabilities and Fund Balance/Net Assets	$ 12,807,200	$ 20,316,815

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

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

	2001	2000 (RESTATED)
REVENUES (Note 1d)		
Charges for Services		
IDRB Program fees	$ 840,450	$ 1,113,030
Other fees	772,616	
Operating Grants and Contributions		
Community Development Block Grant (federal) (Note 7)	38,169,807	52,986,737
Community Development Block Grant (local and others) (Note 7)	2,254,864	1,631,050
Employment Services (federal)	770,000	
Miscellaneous Revenues		
Investment income		38,457
Payments from General Fund	65,316,338	115,333,314
Payments from Tobacco Settlement Trust Fund	50,000,000	50,000,000
Loan and other interest	525,675	
Tribal gaming (Note 7)	9,294,225	7,446,294
Miscellaneous	3,675,426	1,461,254
Total Revenues	$ 171,619,402	$ 230,010,135
EXPENDITURES (Note 1d)		
Administrative	$ 203,521	$ 2,686
Bad debts	3,588,638	
Community Development Block Grant (Note 7)	40,663,095	55,045,958
Payments to MEDC	126,880,019	174,941,176
Payments to General Fund (indirect)	187,196	
Total Expenditures	$ 171,522,468	$ 229,989,820
Excess of Revenues Over Expenditures/Change in Net Assets	$ 96,934	$ 20,315
Fund Balance/Net Assets - Beginning	79,232	58,917
Fund Balance/Net Assets - Ending	$ 176,166	$ 79,232

The accompanying notes are an integral part of 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.

MSF is governed by a 9-member board of directors that consists of the director of the Department of Management and Budget (DMB), the State Treasurer, and 7 members appointed by the Governor with the advice and consent of the Senate.

Executive Order No. 1999-1, effective April 5, 1999, transferred MSF to DMB as an autonomous agency. The Executive Order also transferred the following programs and functions of the Michigan Jobs Commission to MSF:

Capital Resources Group
Commercial Redevelopment Act
Community Development Block Grants (CDBG)
Department of Economic Expansion and Economic Expansion Council
Economic Development Corporations Act
Economic Development Job Training
K.I. Sawyer Conversion Authority
Michigan Business Incubation Act
Michigan Economic Growth Authority
Michigan Enterprise Zone Authority

Michigan International Trade Authority
Michigan Renaissance Zone Act
Michigan Training Incentive Fund
Michigan Travel Commission
Michigan Urban Land Assembly Act
Minority, Women, and Small Business Services Units
Neighborhood Enterprise Zones
Office of Business and Education Coordination
Office of Film and Television Services
Office of the Michigan Business Ombudsman
Office of the Small Business Clean Air Ombudsman
Personal Property Tax Exemption
Plant Rehabilitation and Industrial Development Districts
State Education Tax Exclusion
Travel Michigan
Wurtsmith Conversion 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.

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. <u>Basis of Presentation</u>

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 with 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 accounted for as a governmental fund. The accompanying financial statements present only MSF and are not intended to present fairly the financial position and results of operations of the State of Michigan or its component units.

c. <u>Measurement Focus and Basis of Accounting</u>

The term "measurement focus" refers to what is being measured, and the term "basis of accounting" refers to when revenues and expenditures are recognized in the accounts and reported in the financial statements. The basis of accounting relates to the timing of the measurement made, regardless of the measurement focus applied.

Governmental fund types are accounted for using the modified accrual basis of accounting. The modified accrual basis emphasizes the measurement of current financial resources and obligations. Revenues are recorded when they are measurable and available to finance expenditures of the current period. Revenues are considered to be available when collected within the current period or soon enough thereafter to pay liabilities of the current period. Generally, this is within 12 months. Expenditures are recorded at the time that fund liabilities are incurred.

New accounting standards were adopted in fiscal year 2000-01. MSF adopted GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, as amended by Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*: *Omnibus*, and modified by Statement No. 38, *Certain*

Financial Statement Note Disclosures. Statement No. 34, as amended and modified, commonly referred to as the new reporting model, retained much of the old reporting and disclosure requirements under the prior reporting model, with certain modifications and newly added information. The most significant effect on MSF's financial statements was the reclassification of operating transfers to operating revenues and the addition of the management's discussion and analysis as required supplementary information. 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 to the government-wide level. Because this entity does not have any reconciling items, the statements are presented using one column and 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, CDBG from the U.S. Department of Housing and Urban Development, Employment Services 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 2000-01 and 1999-2000.

(2) Expenditures: CDBG pass-through grants and other minor administrative expenditures. Expenditures for the Employment

Services grant from the U.S. Department of Labor were recorded in MEDC. Also included in expenditures are the tribal gaming revenue, IDRB issuance fees, and State appropriation collected by or appropriated to MSF and transferred to MEDC during fiscal years 2000-01 and 1999-2000.

e. Investments

All investments of MSF, along with liabilities, were transferred to MEDC during fiscal year 1998-99.

f. Compensated Absences

The accumulated compensated absences liability is recorded in MEDC.

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, 2001 were $60,250, which was covered by federal depository insurance and was classified in GASB credit risk category 1. As of September 30, 2000, the deposit amounts were $79,163, which was covered by federal depository insurance.

b. Investments

No investment activities occurred during the fiscal year.

Note 3 Accounts Receivable and Other Assets

MSF accounts receivable and other assets totaled $12,613,105 at September 30, 2001 ($20,237,653 at September 30, 2000). These balances consisted of:

	Fiscal Year	
	2000-01	1999-2000
Federal government (CDBG)	$ 7,299,243	$11,880,759
Amounts due from local units	2,000	
Other current assets:		
Tribal gaming revenue	5,298,031	8,299,854
Miscellaneous	13,831	57,039
Total Accounts Receivable and Other Assets	$12,613,105	$20,237,653

Note 4 Loans Receivable

All loans receivable were transferred to MEDC on May 1, 1999.

Note 5 Bond Programs

MSF and a predecessor entity (the Michigan Job Development Authority) issued industrial development revenue bonds (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, including possible default, 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, 2001 was $5,771,118,339 ($5,182,458,339 through September 30, 2000). The total amount of bonds issued by MSF under the Taxable Bond Program for the period October 1, 2000 through September 30, 2001 was $8,290,000 ($785,000 during the previous fiscal year).

Note 6 Commitments and Contingencies

Taxpayers of Michigan Against Casinos, et al. v *State of Michigan*

In January 2000, an Ingham County circuit judge issued a declaratory ruling that the four new compacts were adopted in an unconstitutional manner. The State has appealed that ruling. It is not anticipated that this ruling will have an immediate effect on payments from the tribes because the compacts remain in effect until a federal court rules that they are void. It is not anticipated that federal authorities would or could pursue such a ruling until after State appeals are exhausted.

Note 7 Major Revenue Sources

The implementation of GASB Statement No. 34 requires that amounts received from State appropriations be treated as direct revenue. In prior years, these were recorded as "Operating Transfers In." MSF recorded $65,316,338 ($115,333,314 in fiscal year 1999-2000) and $50,000,000 ($50,000,000 in fiscal year 1999-2000) received from the State General Fund and Tobacco Settlement Trust Fund appropriations, respectively, as revenues.

MSF recorded $40,424,671 ($54,617,786 in fiscal year 1999-2000) in revenue and $40,663,095 ($55,045,957 in fiscal year 1999-2000) in expenditures during fiscal year 2000-01 for the CDBG Program. This amount represented approximately 71.8% (84.4% in fiscal year 1999-2000) of total revenues (excluding funding from State appropriations) for the fiscal year ended September 30, 2001.

Another major revenue source for MSF is its 8% share of the net revenues derived from the class III electronic games of chance of several casinos located throughout Michigan. During the fiscal year ended September 30, 2001, revenue was recognized from this source in the amount of $9,294,225 ($7,446,294 during the previous fiscal year). This amount represented approximately 16.5% (11.5% in fiscal year 1999-2000) of total revenues (excluding funding from State appropriations) for the fiscal year ended September 30, 2001.

The opening of new tribal casinos and the licensure of casinos in Detroit pursuant to an initiative approved by Michigan voters in 1996 ended the obligation of seven tribes to make payments to MSF. Under a federal court agreement with the State, five tribes ceased making payments in June 1999.

Two casinos stopped remitting required payments after February 19, 1999. In November 2001, the U.S. Court of Appeals for the Sixth Circuit upheld the judgment from a lower court releasing of all seven tribes from their obligation under the 1993 compact to make payments to MSF. No further appeal is planned. Considering no plans for further appeal by the MSF Board of Directors, $3,588,638 was written off for the gaming revenue receivable for the period February through June 1999 from two casinos that stopped making payments in February 1999. This has resulted in the reduction of receivables from casinos as well as the amount payable to MEDC.

New compacts with four additional tribes were approved by a legislative resolution in December 1998. During fiscal year 2000-01, two of these four casinos contributed revenue to MSF. Revenue received from these four casinos will replace revenue lost from the earlier compact with seven tribes, to some extent, and will enable MSF/MEDC to continue to pursue its intended mission of aiding economic development in Michigan.

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

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

February 15, 2002

Mr. Doug Rothwell, President
Michigan Strategic Fund
300 N. Washington Square
Lansing, Michigan

Dear Mr. Rothwell:

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, 2001 and September 30, 2000 and have issued our report thereon dated February 15, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether 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 grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered 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 assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting 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 financial reporting that, in our judgment, could adversely affect the Michigan Strategic Fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable condition is described in 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 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we do not believe that the reportable condition identified in the previous paragraph is a material weakness.

This report is intended solely for the information and use of the Michigan Strategic Fund's Board of Directors and management and the Legislature 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

FINDING, RECOMMENDATION, AND ENTITY PRELIMINARY RESPONSE

FINDING

1. Mail Opening and Cash Handling

The Michigan Strategic Fund (MSF) did not have procedures to ensure effective internal control related to the mail opening and cash handling processes.

Department of Management and Budget (DMB) Administrative Guide procedures have established specific processes for opening mail and the receipt of cash. DMB Administrative Guide procedure 1270.02 requires mail openers to prepare a cash receipts log and to restrictively endorse checks. This procedure also states that cash from receipt to verification of deposits should not be entrusted to only one employee and that cash should be stored in a secure location until deposited. DMB Administrative Guide procedure 1210.04 further states that cash received by agencies must be deposited with the State Treasurer or in a State Treasurer's account at a commercial bank on the day of receipt or no later than close of business the following day.

We noted the following control weaknesses:

a. MSF's mailroom had only one person opening the mail and preparing the cash receipts log, and this person did not restrictively endorse checks when the mail was opened.

b. One staff person in the Industrial Development Revenue Bond (IDRB) Program received and deposited checks. During fiscal year 2000-01, the Program recorded over $840,000 of revenue for IDRB fees. This individual did not maintain a log of checks received or any other records to identify the source of the checks. Our testing of the IDRB application fee process did not disclose any improprieties.

c. MSF allowed one staff person to receive and maintain the checks received for fees of the Michigan Economic Growth Authority (MEGA), another MSF program. However, this person had an informal log within the individual files that recorded the receipt of the checks and the checks were deposited through the cashier. During fiscal year 2000-01, MSF deposited over $290,000 in MEGA fees.

d. Staff in the IDRB and MEGA Programs maintained checks at their offices and frequently did not deposit the checks for several weeks. During this time, the checks were not restrictively endorsed and were not always kept in a locked secure location.

e. Checks totaling $45,000 received in one fiscal year were not deposited and recorded as revenue in the fiscal year received, but were recorded in the subsequent year when the checks were deposited. Because the checks were nonrefundable, this revenue should have been recognized when received.

MSF's failure to adhere to proper internal control procedures may result in a loss of control over the cash receipts operations and hinders accountability for proper and timely deposits of checks. In addition, the delay in depositing checks results in lost interest and can result in revenue reporting errors.

RECOMMENDATION

We recommend that MSF develop and implement procedures to ensure effective internal control related to the mail opening and cash handling processes.

ENTITY PRELIMINARY RESPONSE

MSF agrees with Finding 1.a. and informed us that, currently, a mailroom staff person and a temporary employee open mail daily. Checks are logged and delivered to the finance unit. In the absence of the temporary employee, MSF has a process in place to have an alternate staff person be present while opening the mail on a random basis.

The mailroom receives checks payable to various entities, such as the State of Michigan, MSF, and the Michigan Economic Development Corporation. Mailroom staff are not able to distinguish and appropriately restrictively endorse these checks. There is an alternate process in place whereby the mailroom delivers all receipts and a log to the cashier's office. The cashier reviews and restrictively endorses these checks appropriately, and the checks are then deposited into the appropriate account.

MSF also agrees with Finding 1.b. through 1.e. and now has implemented procedures and policies to address the findings. Checks for the MEGA and IDRB fees are delivered by the mailroom to the cashier and are deposited and recorded promptly per DMB Administrative Guide procedure 1210.04.

Glossary of Acronyms and Terms

CDBG	Community Development Block Grant.
detailed employees	The temporary assignment of employees from a governmental entity to another business entity. Employees in this capacity continue to receive the same compensation and benefits of the original employer, but receive day-to-day direction (work assignments and supervision) from the entity they are detailed to.
DMB	Department of Management and Budget.
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.
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.
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 misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and/or financial statements 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.

reportable condition A matter coming to the auditor's attention relating to a deficiency in the design or operation of internal control that, in the auditor's judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial schedules and/or financial statements.

unqualified opinion An auditor's opinion in which the auditor states that 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.