



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

Audit report information may be accessed at:

<http://audgen.michigan.gov>



Michigan

Office of the Auditor General

REPORT SUMMARY

Financial Audit

Michigan Strategic Fund

(A Component Unit of the State of Michigan)

October 1, 2003 through September 30, 2005

Report Number:
64-801-06

Released:
June 2006

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.

~ ~ ~ ~ ~ ~ ~ ~ ~

Internal Control Over Financial Reporting

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

~ ~ ~ ~ ~ ~ ~ ~ ~

Noncompliance and 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*.

~ ~ ~ ~ ~ ~ ~ ~ ~

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, effective April 5, 1999, transferred MSF to the Department of Management and Budget as an autonomous agency. This Executive Order also 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 the programs transferred to MSF.

Executive Order No. 2003-18, effective December 7, 2003, transferred MSF as an autonomous agency to the Department of Labor and Economic Growth (DLEG).

Effective November 21, 2005, Act 225, P.A. 2005, transferred MSF as an autonomous agency from DLEG to the Department of Treasury.

~ ~ ~ ~ ~ ~ ~ ~ ~

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
201 N. Washington Square
Lansing, Michigan 48913

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

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



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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

June 6, 2006

Mr. James C. Epolito, President
Michigan Strategic Fund
300 North Washington Square
Lansing, Michigan

Dear Mr. Epolito:

This is our report on the financial audit of the Michigan Strategic Fund (MSF), a component unit of the State of Michigan, for the period October 1, 2003 through September 30, 2005.

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 required supplementary information. This report also contains our independent auditor's report on internal control over financial reporting and on compliance and other matters and a glossary of acronyms and terms.

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

AUDITOR GENERAL

TABLE OF CONTENTS

MICHIGAN STRATEGIC FUND

	<u>Page</u>
INTRODUCTION	
Report Summary	1
Report Letter	3
INDEPENDENT AUDITOR'S REPORT	
Independent Auditor's Report on the Financial Statements	8
MANAGEMENT'S DISCUSSION AND ANALYSIS	
Management's Discussion and Analysis	11
FINANCIAL STATEMENTS	
Michigan Strategic Fund Financial Statements	
Fund Balance Sheet and Statement of Net Assets	18
Fund Statement of Revenues, Expenditures, and Changes in Fund Balance and Statement of Activities	19
Notes to the Financial Statements	20
REQUIRED SUPPLEMENTARY INFORMATION -	
BUDGETARY REPORTING	
Budgetary Comparison Schedule and Budget-to-GAAP Reconciliation	26
Notes to Required Supplementary Information - Budgetary Reporting	28

INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND COMPLIANCE

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters	30
--	----

GLOSSARY

Glossary of Acronyms and Terms	33
--------------------------------	----

INDEPENDENT AUDITOR'S REPORT



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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

Independent Auditor's Report on
the Financial Statements

Mr. James C. Epolito, President
Michigan Strategic Fund
300 North Washington Square
Lansing, Michigan

Dear Mr. Epolito:

We have audited the accompanying 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, 2005 and September 30, 2004, 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, 2005 and September 30, 2004 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, 2005 and September 30, 2004 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 12, 2006 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 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 management's discussion and analysis on pages 11 through 15 and the budgetary comparison schedule and budget-to-GAAP reconciliation and corresponding notes on pages 26 through 28 are not a required part of the basic financial statements but are 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, 2004 was not presented because this information was presented in the Michigan Strategic Fund's prior year audited financial statements.

AUDITOR GENERAL

January 12, 2006

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, 2005. 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 (DLEG). Effective November 21, 2005, Act 225, P.A. 2005, transferred MSF as an autonomous agency from DLEG to the Department of Treasury. 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 \$148,859 at September 30, 2005 and by \$65,520 at September 30, 2004. MSF's net assets primarily reflect cash on hand at the end of the fiscal year. MSF's total net assets increased by \$83,339 during fiscal year 2004-05.

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

	2005	2004
Amounts due from federal government	\$ 16,201,084	\$ 11,378,558
Cash and equity in common cash	582,604	824,054
Other current assets	96,359	13,034
 Total Assets	 <u>\$ 16,880,047</u>	 <u>\$ 12,215,646</u>
 Current liabilities	 <u>\$ 16,731,188</u>	 <u>\$ 12,150,126</u>
Total Liabilities	\$ 16,731,188	\$ 12,150,126
 Total Fund Balance/Net Assets	 <u>148,859</u>	 <u>65,520</u>
Total Liabilities and Fund Balance/Net Assets	<u>\$ 16,880,047</u>	<u>\$ 12,215,646</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 **current liabilities**, which primarily include amounts payable to the subgrantees from these federal pass-through funds. These line items increased significantly when compared with fiscal year 2003-04 because of a significant increase in grant reimbursement requests at the end of the fiscal year.

In fiscal years prior to fiscal year 2003-04, **other current assets** consisted primarily of receivables for the 8% share of revenues collected from two Indian tribes, which is paid

in accordance with the terms of the tribes' 1998 compact agreement with the State. Because the tribes contend that the Club Keno game, introduced by the State Lottery, violated the terms of the compact agreement, the tribes have placed payments for fiscal years 2004-05 and 2003-04 into an escrow account rather than submitting them to MSF, pending the resolution of this matter via court litigation. Based on information provided by the tribes, MSF estimated that the tribes placed a total of \$22.1 million relating to fiscal years 2004-05 and 2003-04 into the escrow account.

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**

	2005	2004
Revenues		
Charges for services	\$ 1,730,020	\$ 1,337,539
Operating grants and contributions	50,826,410	35,988,802
Payments from the State of Michigan	63,697,535	47,986,911
Tribal gaming	148,559	2,070,053
Other	545,677	285,973
Total Revenues	\$ 116,948,202	\$ 87,669,277
 Expenditures/Expenses		
CDBG	\$ 50,589,912	\$ 35,416,226
Payments to MEDC	65,164,122	51,507,094
Other	1,110,830	736,936
Total Expenditures/Expenses	\$ 116,864,863	\$ 87,660,257
 Excess of Revenues Over Expenditures/Expenses/		
Change in Net Assets	\$ 83,339	\$ 9,020
Fund Balance/Net Assets - Beginning	65,520	56,500
Fund Balance/Net Assets - Ending	\$ 148,859	\$ 65,520

Charges for services primarily consist of industrial development revenue bond (IDRB) issuance fees and application fees/administrative fees for the Michigan Economic Growth Authority (MEGA) and Brownfield programs. 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 2004-05, there was an increase in fee revenue (charges for services) primarily because more MEGA and Brownfield projects matured during fiscal year 2004-05 compared with the prior fiscal year resulting in increased administrative fees collected.

Operating grants and contributions increased primarily because of an increase in CDBG federal pass-through grant expenditures and corresponding federal revenues by the subgrantees. CDBG funds are disbursed to communities on a reimbursement basis for infrastructure developments. MSF developed a program to accelerate grants awarded using available prior years' carry-forward CDBG funds for reimbursement to communities for infrastructure projects. This resulted in increased grant expenditures and corresponding federal revenues compared with fiscal year 2003-04.

Payments from the State of Michigan primarily consist of the State's General Fund and Tobacco Settlement Trust Fund appropriated payments to MSF. Payments from the State of Michigan increased in fiscal year 2004-05 as a result of the increase in the State appropriations from the State General Fund for the Technology Tri-Corridor for Life Sciences Initiative (\$15.0 million). This also accounts for increased payments to the Michigan Economic Development Corporation (MEDC) in fiscal year 2004-05 when compared with fiscal year 2003-04.

Tribal gaming revenues were substantially lower in fiscal years 2004-05 and 2003-04 as compared with prior fiscal years because two tribes placed the payments for fiscal years 2004-05 and 2003-04 into an escrow account rather than submitting them to MSF because the tribes contend that the Club Keno game, introduced by the State Lottery, violated the terms of the compact agreement. Based on information provided by the tribes, MSF estimated that the tribes placed a total of \$22.1 million into the escrow account relating to fiscal years 2004-05 and 2003-04.

Expenditures/Expenses primarily consist of CDBG expenditures and payments to MEDC. CDBG expenditures increased because of MSF's program to accelerate grants

awarded for infrastructure projects. Payments to MEDC increased substantially because of a net increase in State appropriations to fund programs administered by MEDC.

Other Pertinent Information

During fiscal year 1996-97 through fiscal year 2004-05, MSF disbursed \$36.1 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, 2005, local entities received \$16.0 million in job credits and repaid \$4.8 million. In the event that no further jobs are created by these local entities, MSF may receive up to \$15.4 million in future years. These returned funds are treated as recaptured funds and, per federal regulation, are returned to the federal grantee.

FINANCIAL STATEMENTS

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

	<u>2005</u>	<u>2004</u>
ASSETS		
Current Assets:		
Cash (Note 2)	\$ 50,000	\$ 50,000
Equity in common cash	532,604	774,054
Amounts due from federal government	16,201,084	11,378,558
Other current assets	96,359	13,034
Total Current Assets	<u>\$ 16,880,047</u>	<u>\$ 12,215,646</u>
Total Assets	<u>\$ 16,880,047</u>	<u>\$ 12,215,646</u>
LIABILITIES		
Current Liabilities:		
Accounts payable and other liabilities	\$ 16,503,196	\$ 11,890,977
Amounts due to primary government	11,463	13,610
Deferred revenue	216,530	245,540
Total Current Liabilities	<u>\$ 16,731,188</u>	<u>\$ 12,150,126</u>
Total Liabilities	<u>\$ 16,731,188</u>	<u>\$ 12,150,126</u>
FUND BALANCE/NET ASSETS		
Unreserved fund balance/Unrestricted net assets	\$ 148,859	\$ 65,520
Total Fund Balance/Net Assets	<u>\$ 148,859</u>	<u>\$ 65,520</u>
Total Liabilities and Fund Balance/Net Assets	<u><u>\$ 16,880,047</u></u>	<u><u>\$ 12,215,646</u></u>

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

	<u>2005</u>	<u>2004</u>
REVENUES		
Charges for Services		
IDRB issuance fees	\$ 324,173	\$ 363,669
Other fees	1,405,848	973,870
Operating Grants and Contributions		
Community Development Block Grants (federal) (Note 4)	47,318,758	33,281,869
Community Development Block Grants (local and others) (Note 4)	3,066,676	2,047,192
Employment Service (federal)	440,976	659,741
Payments From the State of Michigan		
Payments from General Fund (Note 4)	53,697,535	37,986,911
Payments from Tobacco Settlement Trust Fund (Note 4)	10,000,000	10,000,000
Other		
Tribal gaming (Note 4)	148,559	2,070,053
Payment from MEDC	52,637	15,210
Miscellaneous	493,039	270,763
Total Revenues	<u>\$ 116,948,202</u>	<u>\$ 87,669,277</u>
EXPENDITURES/EXPENSES		
Administrative	\$ 842,348	\$ 509,760
Community Development Block Grants	50,589,912	35,416,226
Payments to MEDC	65,164,122	51,507,094
Payments to General Fund (indirect and refund)	268,482	227,176
Total Expenditures/Expenses	<u>\$ 116,864,863</u>	<u>\$ 87,660,257</u>
Excess of Revenues Over Expenditures/Expenses/ Change in Net Assets	\$ 83,339	\$ 9,020
Fund Balance/Net Assets - Beginning	<u>65,520</u>	<u>56,500</u>
Fund Balance/Net Assets - Ending	<u>\$ 148,859</u>	<u>\$ 65,520</u>

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 the 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 (DLEG). MSF remains an autonomous agency. The Executive Order also transferred the MSF Board of Directors' position designated for the director of the Department of Management and Budget to the director of DLEG.

MSF is governed by a nine-member Board of Directors that consists of the director of DLEG, 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 transferred to MSF from State appropriations for fiscal years 2004-05 and 2003-04.
- (2) Expenditures: CDBG pass-through grants and other minor administrative expenditures. Also included in expenditures are the funds transferred to MEDC during fiscal years 2004-05 and 2003-04

for the tribal gaming revenue, IDRБ issuance fees, Michigan Economic Growth Authority and Brownfield fees, Employment Service grant, and State appropriations to MSF.

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, 2005 and at September 30, 2004 were \$50,000, which was covered by federal depository insurance and hence was not exposed to custodial credit risk.

b. Investments

No investment activities occurred during either fiscal year.

Note 3 Bond Programs

MSF and a predecessor entity (the Michigan Job Development Authority) issued IDRБs. 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 IDRБs issued by MSF and its predecessor entity for the period January 1, 1979 through September 30, 2005 was \$7,011,747,339 (\$6,767,368,339 through September 30, 2004). The total amount of bonds issued by MSF under the Taxable Bond Program for the period October 1, 2004 through September 30, 2005 was \$9,700,000 (\$955,000 for the period October 1, 2003 through September 30, 2004).

Note 4 Major Revenue Sources

The implementation of GASB Statement No. 34 requires that amounts received from State appropriations be treated as direct revenue. MSF recorded

\$53,697,535 (\$37,986,911 in fiscal year 2003-04) and \$10,000,000 (\$10,000,000 in fiscal year 2003-04) received from the State General Fund and Tobacco Settlement Trust Fund appropriations, respectively, as revenues in fiscal year 2004-05.

MSF recorded \$50,385,434 (\$35,329,061 in fiscal year 2003-04) in revenue during fiscal year 2004-05 for the CDBG Program. This amount represented approximately 94.6% (89.0% for the fiscal year ended September 30, 2004) of total revenues (excluding funding from State appropriations) for the fiscal year ended September 30, 2005.

MSF had been receiving an 8% share of the net revenues collected from two Indian tribes (Little River Band of Ottawa Indians and Little Traverse Bay Band of Odawa Indians), which was paid in accordance with the terms of the tribes' 1998 compact agreement with the State. The tribes have placed the payments for fiscal years 2004-05 and 2003-04 into an escrow account rather than submitting them to MSF. The tribes contend that the Club Keno game, introduced by the State Lottery, violated the terms of the compact agreement. Based on information provided by the tribes, MSF estimated that the tribes placed a total of \$22.1 million into the escrow account for both fiscal years 2003-04 and 2004-05.

The State of Michigan and MEDC filed a lawsuit challenging the defendants' (Little River Band of Ottawa Indians and Little Traverse Bay Band of Odawa Indians) withholding of payments and seeks an order compelling full payments of these funds. The matter is in discovery and likelihood of successful outcome cannot be assessed.

Note 5 Subsequent Event

Effective November 21, 2005, Act 225, P.A. 2005, transferred MSF as an autonomous agency from DLEG to the Department of Treasury. The Act also appropriated \$394 million, financed by the tobacco settlement securitization, to MSF for appropriation year 2005-06 for various programs and requires the MSF Board of Directors to oversee the programs.

REQUIRED SUPPLEMENTARY INFORMATION - BUDGETARY REPORTING

MICHIGAN STRATEGIC FUND
 Budgetary Comparison Schedule and Budget-to-GAAP Reconciliation
For the Fiscal Years Ended September 30

Statutory/Budgetary Basis				2005		Variance With Final Budget
	Original Budget	Final Budget	Actual			
Beginning budgetary fund balance	\$ 65,520	\$ 65,520	\$ 65,520	\$ 65,520	\$ 0	0
Resources (inflows):						
Revenues and Other Sources:						
Charges for services (Note 2)	\$ 104,100	\$ 104,100	\$ 1,730,021	\$ 1,730,021	\$ (1,625,921)	
Operating grants and contributions from federal agencies	53,014,300	53,014,300	50,826,410	50,826,410	2,187,890	
Payments from the State of Michigan:						
From the General Fund	54,106,600	53,716,600	53,697,535	53,697,535	19,065	
From the Tobacco Settlement Trust Fund	10,000,000	10,000,000	10,000,000	10,000,000	0	
Other miscellaneous	903,100	903,100	694,236	694,236	208,864	
Total Revenues and Other Sources	<u>\$ 118,128,100</u>	<u>\$ 117,738,100</u>	<u>\$ 116,948,202</u>	<u>\$ 116,948,202</u>	<u>\$ 789,898</u>	
Total Resources Available	<u>\$ 118,193,620</u>	<u>\$ 117,803,620</u>	<u>\$ 117,013,722</u>	<u>\$ 117,013,722</u>	<u>\$ 789,898</u>	
Charges (outflows):						
Expenditures, Transfers Out, and Encumbrances:						
Administration (Note 2)	\$ 52,558,501	\$ 52,558,501	\$ 842,348	\$ 842,348	\$ (842,348)	
Community Development Block Grants						
Payments to MEDC:						
Administration	2,732,400	2,732,400	2,731,780	2,731,780	620	
Job creation services	17,042,199	16,902,199	16,020,236	16,020,236	881,963	
Michigan Promotion Program	5,717,500	5,717,500	5,709,646	5,709,646	7,854	
Economic Development Job Training Grants	10,048,000	9,798,000	9,794,623	9,794,623	3,377	
Technology Tri-Corridor for Life Sciences Initiative	30,000,000	30,000,000	30,000,000	30,000,000	0	
Human resources optimization user charges	29,500	29,500	25,175	25,175	4,325	
Transfers to MEDC for IDRB, MEGA, and casino revenue (Note 2)						
Payments to General Fund						
Total Charges	<u>\$ 118,128,100</u>	<u>\$ 117,738,100</u>	<u>\$ 116,864,863</u>	<u>\$ 116,864,863</u>	<u>\$ 873,237</u>	
Reconciling Items:						
Encumbrances	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	
Net Reconciling Items	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	
Ending Budgetary Fund Balance	<u>\$ 65,520</u>	<u>\$ 65,520</u>	<u>\$ 148,859</u>	<u>\$ 148,859</u>	<u>\$ (83,339)</u>	

Budget-to-GAAP Reconciliation

Resources (inflows):		
Actual amount (budgetary basis) of "Total Resources Available"		\$ 117,013,722
Differences - Budget to GAAP:		
Beginning budgetary fund balance		(65,520)
Total Revenues (GAAP basis) on the Statement of Revenues, Expenditures, and Changes in Fund Balance		<u>\$ 116,948,202</u>
Charges (outflows):		
Actual amount (budgetary basis) of "Total Charges"		\$ 116,864,863
Differences - Budget to GAAP		
Total Expenditures (GAAP basis) on the Statement of Revenues, Expenditures, and Changes in Fund Balance		<u>\$ 116,864,863</u>

See accompanying notes to required supplementary information - budgetary reporting.

2004				
Original Budget	Final Budget	Actual	Variance With Final Budget	
\$ 56,500	\$ 56,500	\$ 56,500	\$ 0	

\$ 100,900	\$ 100,900	\$ 1,337,539	\$ (1,236,639)
52,953,300	52,953,300	35,988,802	16,964,498
40,555,900	38,380,109	37,986,911	393,198
10,000,000	10,000,000	10,000,000	0
903,100	903,100	2,356,026	(1,452,926)
<u>\$ 104,513,200</u>	<u>\$ 102,337,409</u>	<u>\$ 87,669,277</u>	<u>\$ 14,668,132</u>
<u>\$ 104,569,700</u>	<u>\$ 102,393,909</u>	<u>\$ 87,725,777</u>	<u>\$ 14,668,132</u>

\$ 52,468,752	\$ 52,468,752	\$ 35,416,226	\$ 17,052,525
			0
4,054,700	2,533,800	2,474,762	59,038
17,224,248	16,569,357	15,454,029	1,115,328
5,717,500	5,717,500	5,717,036	464
10,048,000	10,048,000	10,046,777	1,223
15,000,000	15,000,000	15,000,000	0
			0
	2,814,491	(2,814,491)	
	227,176	(227,176)	
<u>\$ 104,513,200</u>	<u>\$ 102,337,409</u>	<u>\$ 87,660,257</u>	<u>\$ 14,677,152</u>

\$ 0	\$ 0	\$ 0	\$ 0
<u>\$ 56,500</u>	<u>\$ 56,500</u>	<u>\$ 65,520</u>	<u>\$ (9,020)</u>

\$ 87,725,777

(56,500)

\$ 87,669,277

\$ 87,660,257

\$ 87,660,257

Notes to Required Supplementary Information - Budgetary Reporting

Note 1 Statutory Budgetary Presentation

The State of Michigan provides annual legislative appropriations to the Michigan Strategic Fund (MSF) for the Community Development Block Grants (CDBG) Program and for State programs. MSF administers the CDBG Program, and the Michigan Economic Development Corporation (MEDC) administers the State programs. MSF transfers the funding for the State programs to MEDC as required by an interlocal agreement between MSF and MEDC.

For programs financed from restricted revenues, spending authorization is generally contingent upon recognition of the related revenue.

The budgetary comparison schedule presents both the original and final appropriated budgets for fiscal years 2004-05 and 2003-04, as well as the actual resource inflows, outflows, and fund balance stated on the budgetary basis.

The original budget and related estimated revenues represent the spending authority enacted into law by the appropriations bill as of October 1, 2004 and October 1, 2003, respectively. The original budget may include encumbrances and multi-year projects' budgetary carry-forwards from the prior fiscal year. MSF did not have any encumbrances or multi-year projects' budgetary carry-forwards.

The budgetary fund balance represents the total fund balance, net of reserves for noncurrent assets. Reserves for noncurrent assets do not represent current financial resources available for appropriations and are not included for budgetary purposes. MSF did not have any noncurrent assets.

Note 2 Charges for Services

The amounts in the actual column include charges for services collected by MSF for the Brownfield, industrial development revenue bond (IDRB), and Michigan Economic Growth Authority (MEGA) programs and the corresponding cost of administering those programs. All excess fees collected are transferred to MEDC pursuant to the interlocal agreement.

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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. James C. Epolito, President
Michigan Strategic Fund
300 North Washington Square
Lansing, Michigan

Dear Mr. Epolito:

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, 2005 and September 30, 2004, as identified in the table of contents, and have issued our report thereon dated January 12, 2006. 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 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

January 12, 2006

GLOSSARY

Glossary of Acronyms and Terms

CDBG	Community Development Block Grants.
DLEG	Department of Labor and Economic Growth.
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.
GAAP	generally accepted accounting principles.
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 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 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 significant deficiency in the design or operation of internal control that, in the auditor's judgment, could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial schedules and/or financial statements.

