

PERFORMANCE AND FINANCIAL AUDIT
OF THE
HOMEOWNER CONSTRUCTION LIEN RECOVERY FUND
DEPARTMENT OF CONSUMER AND INDUSTRY SERVICES
October 1, 1994 through September 30, 1997

EXECUTIVE DIGEST

HOMEOWNER CONSTRUCTION LIEN RECOVERY FUND

INTRODUCTION

This report contains the results of our performance* and financial* audit of the Homeowner Construction Lien Recovery Fund (HCLRF), Department of Consumer and Industry Services. The financial portion of our audit covered the period October 1, 1994 through September 30, 1997.

AUDIT PURPOSE

This performance and financial audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Performance audits are conducted on a priority basis related to the potential for improving effectiveness* and efficiency*. Financial audits are conducted at various intervals to permit the Auditor General to express an opinion on the State's financial statements. Also, this audit complements the departmentwide financial audit.

BACKGROUND

HCLRF is governed by Sections 570.1101 - 570.1305 of the *Michigan Compiled Laws* (Act 497, P.A. 1980, as amended) and is administered within the Department of Consumer and Industry Services.

* See glossary on page 38 for definition.

HCLRF was established in January 1982 to protect homeowners from lien claims for residential construction and remodeling. It also protects persons providing labor, materials, or equipment for real property improvement.

HCLRF is self-supporting from fees charged to licensees* and other lien claimants. If, on December 1 of any year, the fund balance in HCLRF is less than \$1 million, the director of the Department may require an additional assessment, not to exceed \$50 per person, unless the Legislature adopts a resolution to prohibit an additional assessment.

For fiscal year 1996-97, HCLRF reported expenditures and operating transfers out of \$747,960 and revenues and other financing sources of \$424,045. As of September 30, 1997, HCLRF had one direct employee. In addition, the Department provides fiscal and management services to HCLRF.

**AUDIT OBJECTIVES,
CONCLUSIONS, AND
NOTEWORTHY
ACCOMPLISHMENTS**

Audit Objective: To assess the effectiveness of HCLRF's operations.

Conclusion: Our assessment concluded that HCLRF's operations were generally effective. We noted no reportable conditions* related to the audit objective.

Audit Objective: To assess the adequacy of HCLRF's internal control structure*.

* See glossary on page 38 for definition

Conclusion: Our assessment of the internal control structure disclosed one material weakness* that resulted in a material misstatement* to the financial statements:

- HCLRF operating transfers to the General Fund for fund expenditures exceeded HCLRF expenditures in fiscal year 1994-95 (Finding 4).

We did not report the underlying material weakness that resulted in the financial statement errors in an audit finding under the internal control structure objective because the Department corrected the material weakness during the audit period.

Audit Objective: To assess HCLRF's compliance with applicable laws and regulations that could have a material effect on its financial statements.

Conclusion: Our assessment of compliance with laws and regulations disclosed one instance of noncompliance that resulted in a material misstatement to the financial statements:

- The Department did not maintain HCLRF as a self-supporting fund as required by Sections 570.1201(1) and 570.1201(2) of the *Michigan Compiled Laws*. As a result, the Department understated administrative expenditures and overstated HCLRF fund balance by \$206,555 for the fiscal year ended September 30, 1997. (Finding 1)

The Department agreed with our corresponding recommendations and informed us that it will maintain

* See glossary on page 38 for definition

HCLRF as a self-supporting fund and that a correcting entry will be made.

Our assessment also identified two reportable conditions related to the limit on administrative expenditures and the reassessment of fund members (Findings 2 and 3).

Audit Objective: To audit HCLRF's financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995.

Conclusion: We expressed a qualified opinion on HCLRF's financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995 because the Department did not report all administrative expenditures in HCLRF in fiscal year 1996-97 (Finding 1), the Department did not properly classify a transfer of fee assessment revenue of \$59,048 from the General Fund to HCLRF in fiscal year 1995-96, and operating transfers from HCLRF to the General Fund exceeded HCLRF's expenditures by \$55,083 in fiscal year 1994-95 (Finding 4). The effects of these and other errors identified during our audit of the financial statements are identified on page 22. The results of our audit of the financial statements are further discussed in our independent auditor's report on the financial statements.

**AUDIT SCOPE AND
METHODOLOGY**

Our audit scope was to examine the program and other records of the Homeowner Construction Lien Recovery Fund. Also, our audit scope was to examine the financial records for the period October 1, 1994 through September 30, 1997. Our audit was conducted in accordance with generally accepted auditing standards

** See glossary on page 38 for definition.*

and *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Our methodology included reviewing legislation pertaining to HCLRF and HCLRF procedures. Also, we analyzed HCLRF's lien claim data base and reviewed lien claim files to assess the effectiveness of HCLRF's operations.

**AGENCY RESPONSES
AND PRIOR AUDIT
FOLLOW-UP**

Our audit report includes 4 findings and 5 corresponding recommendations. The Department agreed with 4 of the recommendations and disagreed with the other recommendation.

The Department of Consumer and Industry Services complied with 7 of the 9 prior audit recommendations included within the scope of our current audit. The other 2 recommendations were rewritten for inclusion in this report.

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Ms. Kathleen M. Wilbur, Director
Department of Consumer and Industry Services
G. Mennen Williams Building
Lansing, Michigan

Dear Ms. Wilbur:

This is our report on the performance and financial audit of the Homeowner Construction Lien Recovery Fund, Department of Consumer and Industry Services. The financial portion of our audit covered the period October 1, 1994 through September 30, 1997.

This report contains our executive digest; description of agency; audit objectives, scope, and methodology and agency responses and prior audit follow-up; comments, findings, recommendations, and agency preliminary responses; and independent auditor's reports on the internal control structure, on compliance with laws and regulations, and on the financial statements. This report also contains the Homeowner Construction Lien Recovery Fund financial statements and notes to financial statements and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. 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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Description of Agency

The Homeowner Construction Lien Recovery Fund (HCLRF) is governed by Sections 570.1101 - 570.1305 of the *Michigan Compiled Laws* (Act 497, P.A. 1980, as amended) and is administered by the Department of Consumer and Industry Services. The former Department of Commerce was renamed the Department of Consumer and Industry Services as part of Executive Order 1996-2, effective May 15, 1996.

HCLRF was established in January 1982 to protect homeowners from lien claims for residential construction and remodeling. It also protects persons providing labor, materials, or equipment for real property improvement. Only persons who have paid into HCLRF are entitled to recover from HCLRF. HCLRF will pay a maximum of \$75,000 per residential structure for unsatisfied liens. If the Department makes a payment from HCLRF as a result of actions or inactions of a licensee, HCLRF will file a complaint against a licensee. The licensee's license may be revoked until the licensee has repaid HCLRF the amount paid plus the cost of litigation and interest.

HCLRF is self-supporting from fees charged to licensed residential builders, residential maintenance and alteration contractors, electrical contractors, authorized master plumbers, mechanical contractors, and other lien claimants. HCLRF is to maintain a minimum fund balance of \$1 million. If, on December 1 of any year, the fund balance in HCLRF is less than \$1 million, the director of the Department may require an additional assessment, not to exceed \$50 per person in an assessment period, unless the Legislature adopts a resolution to prohibit the additional assessment. HCLRF fund balance was \$608,297 and \$879,270 as of December 1, 1997 and December 1, 1996, respectively.

For fiscal years 1995-96 and 1994-95, HCLRF expenditures were appropriated in and expended directly from the General Fund. Operating transfers were made from HCLRF to reimburse the General Fund for the expenditures. As discussed in Note 3 of the financial statements, HCLRF expenditures were appropriated in and directly expended from HCLRF beginning in fiscal year 1996-97. For fiscal year 1996-97, HCLRF reported expenditures and operating transfers out of \$747,960 and revenues and other financing sources of \$424,045. As of September 30, 1997, HCLRF had one direct employee. In addition, the Department provides fiscal and management services to HCLRF.

Audit Objectives, Scope, and Methodology and Agency Responses and Prior Audit Follow-Up

Audit Objectives

Our performance and financial audit of the Homeowner Construction Lien Recovery Fund (HCLRF), Department of Consumer and Industry Services, had the following audit objectives:

1. To assess the effectiveness of HCLRF's operations.
2. To assess the adequacy of HCLRF's internal control structure.
3. To assess HCLRF's compliance with applicable laws and regulations that could have a material effect on its financial statements.
4. To audit HCLRF's financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995.

Audit Scope

Our audit scope was to examine the program and other records of the Homeowner Construction Lien Recovery Fund. Also, our audit scope was to examine the financial records for the period October 1, 1994 through September 30, 1997. Our audit was conducted in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our methodology included reviewing legislation pertaining to HCLRF and HCLRF procedures. Also, we analyzed HCLRF's lien claim data base and reviewed lien claim files to assess the effectiveness of HCLRF's operations.

Agency Responses and Prior Audit Follow-Up

Our audit report includes 4 findings and 5 corresponding recommendations. The Department agreed with 4 of the recommendations and disagreed with the other recommendation.

The agency preliminary response which follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and Department of Management and Budget Administrative Guide procedure 1280.02 require the Department of Consumer and Industry Services to develop a formal response to our audit findings and recommendations within 60 days after release of the audit report.

The Department of Consumer and Industry Services complied with 7 of the 9 prior audit recommendations included within the scope of our current audit. The other 2 recommendations were rewritten for inclusion in this report.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS OF OPERATIONS

COMMENT

Audit Objective: To assess the effectiveness of the Homeowner Construction Lien Recovery Fund's (HCLRF's) operations.

Conclusion: Our assessment concluded that HCLRF's operations were generally effective. We noted no reportable conditions related to the audit objective.

INTERNAL CONTROL STRUCTURE

COMMENT

Audit Objective: To assess the adequacy of HCLRF's internal control structure.

Conclusion: Our assessment of the internal control structure disclosed one material weakness that resulted in a material misstatement to the financial statements. HCLRF operating transfers to the General Fund for fund expenditures exceeded HCLRF expenditures in fiscal year 1994-95 (Finding 4). We did not report the underlying material weakness that resulted in the financial statement errors in an audit finding under the internal control structure objective because the Department corrected the material weakness during the audit period.

COMPLIANCE WITH LAWS AND REGULATIONS

COMMENT

Audit Objective: To assess HCLRF's compliance with applicable laws and regulations that could have a material effect on its financial statements.

Conclusion: Our assessment of compliance with laws and regulations disclosed one instance of noncompliance that resulted in a material misstatement to the financial statements. The Department of Consumer and Industry Services did not maintain HCLRF as a self-supporting fund as required by Sections 570.1201(1) and 570.1201(2) of the *Michigan Compiled Laws*. Our assessment also identified two reportable conditions related to the limit on administrative expenditures and the reassessment of fund members.

FINDING

1. Administrative Expenditures Transferred to General Fund

The Department did not maintain HCLRF as a self-supporting fund as required by Sections 570.1201(1) and 570.1201(2) of the *Michigan Compiled Laws*. As a result, the Department understated administrative expenditures and overstated HCLRF fund balance by \$206,555 for the fiscal year ended September 30, 1997.

Sections 570.1201(1) and 570.1201(2) of the *Michigan Compiled Laws* require that HCLRF be self-supporting through assessments and that all wages, professional fees, and other administrative expenditures be charged to and payable from HCLRF. During fiscal year 1996-97, the Department attempted to comply with a 20% administrative expenditure limitation requirement by transferring \$206,555 in salaries and wages and other purchased legal fees from HCLRF to the General Fund. However, that statute does not provide for General Fund authorizations to support HCLRF operations.

Section 1100.101 of the *Codification of Governmental Accounting and Financial Reporting Standards*, published by the Governmental Accounting Standards Board* , requires a governmental accounting system to present fairly and with full disclosure the financial position and results of financial operations and to determine and demonstrate compliance with finance-related legal and contractual provisions.

* See glossary on page 38 for definition.

RECOMMENDATIONS

We recommend that the Department maintain HCLRF as a self-supporting fund as required by Sections 570.1201(1) and 570.1201(2) of the *Michigan Compiled Laws*.

We also recommend that the Department initiate the administrative action necessary to return \$206,555 in administrative expenditures to HCLRF and, accordingly, reduce HCLRF's fund balance.

AGENCY PRELIMINARY RESPONSE

The Department agreed with the first recommendation and will maintain HCLRF as a self-supporting fund. The Department agreed with the second recommendation and informed us that a correcting entry will be made.

FINDING

2. Limit on Administrative Expenditures

The Department did not calculate the 20% limit on HCLRF administrative expenditures in accordance with Section 570.1202(3) of the *Michigan Compiled Laws*.

Section 570.1202(2) of the *Michigan Compiled Laws* limit HCLRF's wages, professional fees, and other administrative expenditures to no more than 20% of the funds collected in the most recent fiscal year. However, Section 570.1202(3) of the *Michigan Compiled Laws* specifies that the Department calculate the administrative expenditures limitation on the basis of the most recent year in which the \$50 fee was assessed and collected for new license applications and renewals. The Department has not assessed license fees for both new applications and renewals since fiscal year 1981-82.

The Department did not comply with Section 570.1202(3) of the *Michigan Compiled Laws* in calculating the 20% limit. The Department used previous fiscal year revenues to calculate the 20% limit on HCLRF administrative expenditures of \$89,000, \$88,600, and \$81,400 for fiscal years 1996-97, 1996-95 and 1994-95, respectively. The Department compared these limits to HCLRF actual

administrative expenditures and identified excess administrative expenditures of \$94,208 and \$112,257 for fiscal years 1996-97 and 1995-96, respectively. The Department should have calculated a 20% limit on administrative expenditures of \$338,628 based on the fiscal year 1981-82 revenues. As a result, HCLRF administrative expenditures did not exceed the 20% limit during fiscal years 1996-97, 1995-96, and 1994-95.

RECOMMENDATION

We recommend that the Department calculate the 20% limit on HCLRF administrative expenditures in accordance with Section 570.1202(3) of the *Michigan Compiled Laws*.

AGENCY PRELIMINARY RESPONSE

The Department disagreed with this finding. The Department contends that the term "renewal" referred to in Section 570.1202(3) of the *Michigan Compiled Laws* refers to builders' relicensure prior to 1982, which was the year HCLRF was created. The Department cited Section 570.1201(1) of the *Michigan Compiled Laws*, which provides for a \$50 assessment of license renewals for 1982 and new license applications. The Department informed us that, subsequent to 1982, only new license applications were assessed the \$50 fee. Therefore, the Department concluded that its calculation of the 20% limit on HCLRF administrative expenditures based on the applicable previous fiscal years' revenues was correct.

EPILOGUE

While the Department does not agree that the assessment and collection of license renewals subsequent to 1982 were required to calculate the 20% limit, the Department informed us that license renewals are subject to additional assessment as provided for by Section 570.1201(2) of the *Michigan Compiled Laws*. Consistently, the Department should recognize that license renewals must be considered to calculate the 20% limit on HCLRF administrative expenditures in accordance with Section 570.1202(3) of the *Michigan Compiled Laws*.

FINDING

3. Reassessment of Fund Members

The Department did not ensure that HCLRF reassessed all fund members as allowed by Section 570.1201(2) of the *Michigan Compiled Laws*. As a result, the Department reduced HCLRF's ability to generate the revenue needed to remain a self-supporting fund as required by Section 570.1201(1) of the *Michigan Compiled Laws*.

HCLRF was initially funded through a \$50 fee assessment charged for license renewals and new license applications during fiscal year 1981-82. HCLRF has continued to assess the \$50 fee for new license applications; however, HCLRF has not reassessed license renewals since fiscal year 1981-82.

Section 570.1201(2) of the *Michigan Compiled Laws* states that, if, on December 1 of any year, the fund balance in HCLRF is less than \$1 million, the director of the Department may require an additional assessment, not to exceed \$50 per person in an assessment period, unless the Legislature adopts a resolution to prohibit the additional assessment. HCLRF fund balance was \$608,297 and \$879,270 as of December 1, 1997 and December 1, 1996, respectively. On each date, the Department did not require an additional assessment, even though the HCLRF fund balance has declined on a continual basis since fiscal year 1991-92. As discussed in Note 6 to the financial statements, HCLRF's declining fund balance raises doubt about its ability to continue beyond fiscal year 1998-99.

RECOMMENDATION

We recommend that the Department ensure that HCLRF reassess all fund members in accordance with Section 570.1201(2) of the *Michigan Compiled Laws*.

AGENCY PRELIMINARY RESPONSE

The Department agreed with the recommendation and will ensure that HCLRF reassesses all fund members.

FINANCIAL ACCOUNTING AND REPORTING

COMMENT

Audit Objective: To audit HCLRF's financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995.

Conclusion: We expressed a qualified opinion on HCLRF's financial statements as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995 because the Department did not report all administrative expenditures in HCLRF in fiscal year 1996-97 (Finding 1), the Department did not properly classify a transfer of fee assessment revenue of \$59,048 from the General Fund to HCLRF in fiscal year 1995-96, and operating transfers from HCLRF to the General Fund exceeded HCLRF expenditures by \$55,083 in fiscal year 1994-95. The effects of these errors identified during our audit of the financial statements are shown in the following table:

| | Overstatement (Understatement) for the Fiscal Year Ended September 30 | | |
|---|--|-------------|-------------|
| | 1997 | 1996 | 1995 |
| Fee assessment revenue | | \$ (59,048) | |
| Administrative expenditures | \$(206,555) | | |
| Operating transfers to the General Fund | | \$ (59,048) | \$ 55,083 |
| HCLRF beginning fund balance | \$ (55,083) | \$ (55,083) | |
| HCLRF ending fund balance | \$ 151,472 | \$ (55,083) | \$ (55,083) |

The results of our audit of the financial statements are further discussed in our independent auditor's report on the financial statements.

FINDING

4. Operating Transfers

HCLRF operating transfers to the General Fund for fund expenditures exceeded HCLRF expenditures by \$468 and \$55,083 for fiscal years 1995-96 and 1994-95, respectively.

During fiscal years 1995-96 and 1994-95, HCLRF revenues and expenditures were recorded in the General Fund and subsequently reimbursed through operating transfers between HCLRF and the General Fund. As discussed in Note 3 of the financial statements, the Department began recording revenue and expenditure transactions directly into HCLRF accounts beginning in fiscal year 1996-97.

HCLRF operating transfers to the General Fund for fund expenditures exceeded HCLRF expenditures by a total of \$55,551 for fiscal years 1995-96 and 1994-95. Department personnel informed us that the operating transfers were based on summaries of expenditures recorded in HCLRF's General Fund accounts. HCLRF and the Department had not properly reconciled HCLRF expenditures with HCLRF operating transfers to the General Fund. Our analysis disclosed that these General Fund accounts included non-HCLRF expenditures. These errors resulted in overstatement of HCLRF operating transfers to the General Fund, understatement of HCLRF fund balance, overstatement of General Fund operating transfers from other funds, and overstatement of the General Fund fund balance for fiscal years 1995-96 and 1994-95.

We noted a material control weakness related to HCLRF operating transfers to the General Fund in the prior audit. In response to the prior audit recommendation, the Department stated that the State's new accounting system, the Michigan Administrative Information Network (MAIN), would allow expenditures to be made directly against HCLRF beginning October 1, 1996. This accounting change resulted in a decrease of operating transfers from \$697,918 in fiscal year 1995-96 to \$5,389 in fiscal year 1996-97. Our review of fiscal year 1996-97 operating transfers disclosed no errors.

RECOMMENDATION

We recommend that the Department initiate the administrative action necessary to reimburse HCLRF for the \$55,551 that was transferred to the General Fund in excess of HCLRF expenditures.

AGENCY PRELIMINARY RESPONSE

The Department agreed with our recommendation and informed us that a correcting entry will be made.

Independent Auditor's Report on
the Internal Control Structure

September 10, 1998

Ms. Kathleen M. Wilbur, Director
Department of Consumer and Industry Services
G. Mennen Williams Building
Lansing, Michigan

Dear Ms. Wilbur:

We have audited the financial statements of the Homeowner Construction Lien Recovery Fund, Department of Consumer and Industry Services, as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995 and have issued our report thereon dated September 10, 1998, which included a qualified opinion on the financial statements.

We conducted our audit in accordance with generally accepted auditing standards and *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.

The management of the Homeowner Construction Lien Recovery Fund and the management of the Department of Consumer and Industry Services are responsible for establishing and maintaining an internal control structure, which operates in conjunction with the Statewide internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future

periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995, we obtained an understanding of the Homeowner Construction Lien Recovery Fund's internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk 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 structure. Accordingly, we do not express such an opinion.

We noted a certain matter involving the internal control structure and its operation that we consider to be a reportable condition under standards established by the American Institute of Certified Public Accountants. A reportable condition involves a matter coming to our attention relating to a significant deficiency in the design or operation of the internal control structure that, in our judgment, could adversely affect the Homeowner Construction Lien Recovery 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 more fully described in Finding 4. The Department corrected the reportable condition during the audit period through an accounting change described in Note 3 of the financial statements. As a result, the reportable condition was not reported in an audit finding under the internal control structure objective.

A material weakness is a reportable condition in which the design or operation of one or more specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities 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 structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we noted the following matter involving the internal control structure and its operation that we consider to be a material weakness as described above. As discussed in Finding 4, Homeowner Construction Lien Recovery Fund operating transfers to the General Fund for fund expenditures exceeded the Homeowner Construction Lien Recovery Fund expenditures in fiscal year 1994-95. The Department corrected the underlying material weakness during the audit period; therefore, it was not reported in an audit finding under the internal control structure objective. This condition was considered in

determining the nature, timing, and extent of the procedures performed in our audit of the financial statements for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995.

AUDITOR GENERAL

Independent Auditor's Report on
Compliance With Laws and Regulations

September 10, 1998

Ms. Kathleen M. Wilbur, Director
Department of Consumer and Industry Services
G. Mennen Williams Building
Lansing, Michigan

Dear Ms. Wilbur:

We have audited the financial statements of the Homeowner Construction Lien Recovery Fund, Department of Consumer and Industry Services, as of and for the fiscal years ended September 30, 1997, September 30, 1996, and September 30, 1995 and have issued our report thereon dated September 10, 1998, which included a qualified opinion on the financial statements.

We conducted our audit in accordance with generally accepted auditing standards and *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.

Compliance with laws, regulations, contracts, and grants applicable to the Homeowner Construction Lien Recovery Fund is the responsibility of the Homeowner Construction Lien Recovery Fund management and the Department of Consumer and Industry Services management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Fund's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements or violations of prohibitions contained in statutes, regulations, contracts, or grants that cause us to

conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instance of noncompliance, the effect of which was not corrected in the Fund's financial statements for the fiscal year ended September 30, 1997.

The Department did not maintain the Fund as a self-supporting fund as required by Sections 570.1201(1) and 570.1201(2) of the *Michigan Compiled Laws*. The Department transferred \$206,555 in Fund administrative expenditures to the General Fund in fiscal year 1996-97. The instance of material noncompliance is more fully described in Finding 1.

We considered this material instance of noncompliance in forming our opinion on whether the Fund's financial statements for the fiscal years ending September 30, 1997, September 30, 1996, and September 30, 1995 are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated September 10, 1998 on those financial statements.

The results of our tests also disclosed the following instances of noncompliance that are required to be reported under *Government Auditing Standards* for which the ultimate resolution cannot presently be determined. The instances of noncompliance are more fully described in Findings 2 and 3.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, the Homeowner Construction Lien Recovery Fund, Department of Consumer and Industry Services, complied, in all material respects, with the provisions referred to in the third paragraph of this report and, with respect to items not tested, nothing came to our attention that caused us to believe that the Fund had not complied, in all material respects, with those provisions.

AUDITOR GENERAL

Independent Auditor's Report on
the Financial Statements

September 10, 1998

Ms. Kathleen M. Wilbur, Director
Department of Consumer and Industry Services
G. Mennen Williams Building
Lansing, Michigan

Dear Ms. Wilbur:

We have audited the accompanying balance sheet of the Homeowner Construction Lien Recovery Fund, Department of Consumer and Industry Services, as of September 30, 1997, September 30, 1996, and September 30, 1995 and the related statement of revenues, expenditures, and changes in fund balance and statement of revenues, expenditures, and changes in fund balance - budget and actual for the fiscal years then ended. These financial statements are the responsibility of the Fund management and the Department management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *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 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 discussed in Note 1b, the accompanying financial statements present only the Homeowner Construction Lien Recovery Fund and are not intended to present fairly the financial position and results of operations of the State of Michigan or its special revenue funds.

As described in Finding 1, the Department did not report all administrative expenditures in the Fund in fiscal year 1996-97. Also, the Department did not properly classify a transfer of fee assessment revenue from the General Fund to the Homeowner Construction Lien Recovery Fund in fiscal year 1995-96. In addition, as described in Finding 4, operating transfers from the Fund to the General Fund exceeded the Homeowner Construction Lien Recovery Fund's expenditures in fiscal year 1994-95. As a result of these errors, administrative expenditures and ending fund balance were overstated \$206,555 and \$151,472 respectively, for fiscal year 1996-97; beginning fund balance was overstated \$55,083 for fiscal year 1996-97; operating transfers to the General Fund and fund assessment revenues were understated \$59,048 for fiscal year 1995-96; beginning and ending fund balance were understated \$55,083 for fiscal year 1995-96; fund assessment revenues and operating transfers to the General Fund were overstated \$55,083 for fiscal year 1994-95; and ending fund balance was understated \$55,083 for fiscal year 1994-95.

In our opinion, except for the items discussed in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Homeowner Construction Lien Recovery Fund as of September 30, 1997, September 30, 1996, and September 30, 1995 and the results of its operations for the fiscal years then ended on the basis of accounting described in Note 1b.

As discussed in Finding 3 and Note 6, the director of the Department did not reassess fund members on December 1, 1997 and December 1, 1996 to increase Fund fee assessment revenues. As a result, the fund balance of the Homeowner Construction Lien Recovery Fund was reduced to a level that raises a concern regarding whether the Fund will continue to meet its financial obligations as they come due after May 1999.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 10, 1998 on our consideration of the Homeowner Construction Lien Recovery Fund's internal control structure and a report dated September 10, 1998 on its compliance with laws and regulations.

AUDITOR GENERAL

HOMEOWNER CONSTRUCTION LIEN RECOVERY FUND
 Department of Consumer and Industry Services
 Balance Sheet
As of September 30

| | <u>1997</u> | <u>1996</u> | <u>1995</u> |
|---|--------------------------|--------------------------|----------------------------|
| ASSETS | | | |
| Cash | \$ 1,550 | \$ 1,050 | \$ 650 |
| Equity in State Treasurer's Common Cash | <u>716,627</u> | <u>988,240</u> | <u>1,240,875</u> |
| Total Assets | <u>\$ 718,177</u> | <u>\$ 989,290</u> | <u>\$ 1,241,525</u> |
| LIABILITIES AND FUND BALANCE | | | |
| Liabilities: | | | |
| Warrants outstanding | \$ 3,420 | \$ 1,300 | \$ 1,050 |
| Accounts payable and other liabilities | 62,357 | 12,240 | 11,830 |
| Amounts due to other funds | <u>566</u> | <u></u> | <u></u> |
| Total Liabilities | \$ 66,343 | \$ 13,540 | \$ 12,880 |
| Fund Balance - Reserved | 100 | | |
| Fund Balance - Unreserved | <u>651,734</u> | <u>975,750</u> | <u>1,228,645</u> |
| Total Liabilities and Fund Balance | <u>\$ 718,177</u> | <u>\$ 989,290</u> | <u>\$ 1,241,525</u> |

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

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HOMEOWNER CONSTRUCTION LIEN RECOVERY FUND
 Department of Consumer and Industry Services
 Statement of Revenues, Expenditures, and Changes in Fund Balance
Fiscal Years Ended September 30

| | 1997 | 1996 | 1995 |
|--|--------------|---------------|---------------|
| REVENUES | | | |
| Miscellaneous: | | | |
| Fee assessments | \$ 328,825 | \$ 359,388 | \$ 318,750 |
| Interest from State Treasurer's Common Cash | 47,379 | 77,246 | 102,173 |
| Other | 47,841 | 8,390 | 21,638 |
| Total Revenues | \$ 424,045 | \$ 445,024 | \$ 442,561 |
| EXPENDITURES | | | |
| Fund Administrative Costs: | | | |
| Department of Consumer and Industry Services - administrative expenditures | \$ (102,246) | \$ | \$ |
| Department of Attorney General | 302,678 | | |
| Special Assistant Attorneys General | 74,454 | | |
| Total Administrative Costs | \$ 274,886 | \$ 0 | \$ 0 |
| Lien claim payments | 467,685 | | |
| Total Expenditures (Note 3) | \$ 742,571 | \$ 0 | \$ 0 |
| Excess of Revenues Over (Under) Expenditures | \$ (318,526) | \$ 445,024 | \$ 442,561 |
| OTHER FINANCING SOURCES (USES) | | | |
| Operating transfers to the General Fund (Note 4) | \$ (5,389) | \$ (697,918) | \$ (914,919) |
| Total Other Financing Sources (Uses) | \$ (5,389) | \$ (697,918) | \$ (914,919) |
| Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses | \$ (323,915) | \$ (252,895) | \$ (472,358) |
| Fund Balance - Beginning of fiscal year | 975,750 | 1,228,645 | 1,701,002 |
| Fund Balance - End of fiscal year (Note 6) | \$ 651,835 | \$ 975,750 | \$ 1,228,645 |

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

HOMEOWNER CONSTRUCTION LIEN RECOVERY FUND
 Department of Consumer and Industry Services
 Statement of Revenues, Expenditures, and Changes in
 Fund Balance - Budget and Actual
Fiscal Years Ended September 30

| Statutory/Budgetary Basis | 1997 | | Variance Favorable (Unfavorable) |
|---|--------------------|---------------------|--|
| | Budget | Actual | |
| REVENUES AND OTHER SOURCES | | | |
| Miscellaneous | \$ 424,045 | \$ 424,045 | \$ 0 |
| Operating Transfers In | | | 0 |
| Total Revenues and Other Sources | <u>\$ 424,045</u> | <u>\$ 424,045</u> | <u>\$ 0</u> |
| EXPENDITURES AND OPERATING TRANSFERS OUT | | | |
| Fund administrative costs and lien claim payments | \$ 747,960 | \$ 747,960 | \$ 0 |
| Total Expenditures and Operating Transfers Out (Notes 3 and 4) | <u>\$ 747,960</u> | <u>\$ 747,960</u> | <u>\$ 0</u> |
| Revenues and Other Sources Over (Under) Expenditures and Operating Transfers Out (Statutory/Budgetary Basis) | <u>\$(323,915)</u> | <u>\$ (323,915)</u> | <u>\$ 0</u> |
| Excess of Revenues and Other Sources Over (Under) Expenditures and Operating Transfers Out (GAAP Basis) | | \$ (323,915) | |
| FUND BALANCE (GAAP BASIS) | | | |
| Beginning balance | | 975,750 | |
| Ending balance (GAAP Basis) (Note 6) | | <u>\$ 651,835</u> | |

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

| 1996 | | | 1995 | | |
|-----------------------------|---------------------|----------------------------------|-----------------------------|---------------------|----------------------------------|
| Budget | Actual | Variance Favorable (Unfavorable) | Budget | Actual | Variance Favorable (Unfavorable) |
| \$ 444,984 | \$ 445,023 | \$ 39 | \$ 442,561 | \$ 442,561 | \$ 0 |
| 59,048 | | (59,048) | | | 0 |
| <u>\$ 504,032</u> | <u>\$ 445,023</u> | <u>\$ (59,009)</u> | <u>\$ 442,561</u> | <u>\$ 442,561</u> | <u>\$ 0</u> |
| | | | | | |
| \$ 1,542,900 | \$ 697,918 | \$ 844,982 | \$ 1,892,500 | \$ 914,919 | \$ 977,581 |
| <u>\$ 1,542,900</u> | <u>\$ 697,918</u> | <u>\$ 844,982</u> | <u>\$ 1,892,500</u> | <u>\$ 914,919</u> | <u>\$ 977,581</u> |
| | | | | | |
| <u><u>\$(1,038,868)</u></u> | <u>\$ (252,895)</u> | <u>\$ 785,975</u> | <u><u>\$(1,449,939)</u></u> | <u>\$ (472,358)</u> | <u>\$ 977,581</u> |
| | \$ (252,895) | | | \$ (472,358) | |
| | | | | | |
| | <u>1,228,645</u> | | | <u>1,701,002</u> | |
| | <u>\$ 975,750</u> | | | <u>\$ 1,228,645</u> | |

Notes to Financial Statements

Note 1 Significant Accounting Policies

a. Reporting Entity

The accompanying financial statements report the financial position and results of operations of the Homeowner Construction Lien Recovery Fund (HCLRF), Department of Consumer and Industry Services, as of and for the fiscal years ended September 30, 1997, September 30, 1996, and, September 30, 1995. HCLRF is part of the State of Michigan's reporting entity and is reported as a special revenue fund in the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*.

The footnotes accompanying these financial statements relate directly to HCLRF. The *SOMCAFR* provides more extensive general disclosures regarding the State's Summary of Significant Accounting Policies, Budgeting and Budgetary Control, Treasurer's Common Cash, Pension Benefits and Other Postemployment Benefits, Compensated Absences, and Contingencies and Commitments.

b. Basis of Accounting and Presentation

The financial statements contained in this report are prepared on the modified accrual basis of accounting. The modified accrual basis of accounting, which emphasizes the measurement of current financial resource flows, is explained in more detail in the *SOMCAFR*.

The accompanying financial statements contained in this report present only the Homeowner Construction Lien Recovery Fund. Accordingly, they are not intended to present fairly the financial position and results of operations for the State of Michigan or its special revenue funds.

Note 2 Budgeting and Budgetary Control

Budgetary amounts in the statement of revenues, expenditures, and changes in fund balance - budget and actual concur with the presentation in the *SOMCAFR*; however, these amounts do not reflect the effect of misstatements to HCLRF's financial statements.

Note 3 Accounting Changes

In prior fiscal years, accounting system limitations prevented the allocation of multi-fund appropriations into more than one fund. Fiscal year 1995-96 and 1994-95 HCLRF appropriations and related expenditures were recorded in the General Fund and were then financed by operating transfers from HCLRF. Beginning October 1, 1996, administrative expenditures and lien claim payments were appropriated and expended directly from HCLRF. This change increased expenditures and decreased operating transfers out by \$742,571 compared with fiscal year 1995-96.

Note 4 Operating Transfers to the General Fund

For the fiscal years ended September, 30, 1996 and September 30, 1995, administrative expenditures (including salaries and wages, retirement, etc.) and lien claim payments were appropriated in and expended directly from the General Fund when HCLRF was incorporated into the Department of Consumer and Industry Services account structure. Transfers, as shown in the following table, were made to cover the administrative expenditures and lien claim payments:

| | Fiscal Years Ended September 30 | |
|--|------------------------------------|------------------------------|
| | 1996 | 1995 |
| Fund Administrative Expenditures: | | |
| Department of Consumer and Industry Services - administrative expenditures | \$ 40,675 | \$ 122,183 |
| Department of Attorney General | 259,809 | 319,425 |
| Special Assistant Attorneys General | 111,683 | 57,535 |
| Office of the Auditor General | 10,200 | 9,400 |
| Department of Treasury | 1,000 | 1,000 |
| Department of Civil Service | 2,794 | 2,700 |
| Total Administrative Expenditures | <u>\$ 426,161</u> | <u>\$ 512,243</u> |
| Lien Claim Payments | <u>271,757</u> | <u>402,676</u> |
| Total Transfers | <u><u>\$ 697,918</u></u> | <u><u>\$ 914,919</u></u> |

Note 5 Future Claims and Cost of Settling Future Claims

HCLRF was originally created by Act 497, P.A. 1980, effective January 1, 1982, and its enabling legislation is contained in Sections 570.1101 - 570.1305 of the *Michigan Compiled Laws*. HCLRF was established to protect homeowners from lien claims filed by contractors, subcontractors, laborers, and suppliers to a maximum of \$75,000 per residential structure. Section 570.1203 of the *Michigan Compiled Laws* provides that a lien claim will be paid from HCLRF only on a court order and that the Attorney General will defend HCLRF.

The allowances for future claim losses and the cost of settling future claims cannot be reasonably estimated at this time. As a result, future claim losses and the cost of settling future claims are not reported as liabilities.

Note 6 Fund Balance

HCLRF fund balance has declined on a continual basis since fiscal year 1990-91 when it was at \$3,191,872 as of September 30, 1991:

| <u>Fiscal Year Ended</u> | <u>Ending Fund Balance</u> | <u>Change From Prior Year</u> |
|--------------------------|----------------------------|-----------------------------------|
| 1991 | \$ 3,191,872 | |
| 1992 | \$ 2,965,190 | \$ (226,682) |
| 1993 | \$ 2,319,855 | \$ (645,335) |
| 1994 | \$ 1,701,002 | \$ (618,853) |
| 1995 | \$ 1,228,645 | \$ (472,357) |
| 1996 | \$ 975,750 | \$ (252,895) |
| 1997 | \$ 651,835 | \$ (323,915) |

HCLRF's recurring losses from operations and the declining fund balance raise doubt about its ability to continue beyond fiscal year 1998-99. Given current financial conditions, the Department projects HCLRF will not be able to meet its financial obligations after May 1999.

Section 570.1201(2) of the *Michigan Compiled Laws* states that, if, on December 1 of any year, the fund balance in HCLRF is less than \$1 million, the director of the Department may require an additional assessment, not to exceed \$50 per person in an assessment period, unless the Legislature adopts

a resolution to prohibit the additional assessment. As shown in the preceding table, HCLRF fund balance decreased below \$1 million during fiscal year 1995-96. HCLRF fund balance was \$608,297 and \$879,270 as of December 1, 1997 and December 1, 1996, respectively. As a result of the current financial condition of HCLRF, the Department is considering an additional assessment to its members.

Glossary of Acronyms and Terms

| | |
|---|---|
| effectiveness | Program success in achieving mission and goals. |
| efficiency | Achieving the most outputs and outcomes practical for the amount of resources applied or minimizing the amount of resources required to attain a certain level of outputs or outcomes. |
| financial audit | An audit that is designed to provide reasonable assurance about whether the financial statements of an audited entity are fairly presented in conformity with generally accepted accounting principles. |
| GAAP | generally accepted accounting principles. |
| Governmental Accounting Standards Board | This Board provides authoritative guidance on accounting and reporting for state and local governmental entities. |
| HCLRF | Homeowner Construction Lien Recovery Fund. |
| internal control structure | The management control environment, management information system, accounting system, and control policies and procedures established by management to provide reasonable assurance that goals are met; that resources are safeguarded; that resources are used in compliance with laws and regulations; that valid and reliable performance related information is obtained and reported; and that financial transactions are properly accounted for and reported. |
| licensee | A licensed residential builder, residential maintenance and alteration contractor, electrical contractor, authorized master plumber, or mechanical contractor. |

| | |
|------------------------------|--|
| material misstatement | A misstatement in the financial statements that causes the statements to not present fairly the financial position or the results of operations in conformity with generally accepted accounting principles. |
| material weakness | A serious reportable condition in which the design or operation of one or more of the internal control structure elements including management controls does not reduce to a relatively low level the risk that errors or irregularities, in amounts that would be material in relation to the financial statements, would not be prevented or detected. |
| performance audit | An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action. |
| qualified opinion | An auditor's opinion in which the auditor expresses reservations about the fair presentation of the financial statements in conformity with generally accepted accounting principles. |
| reportable condition | A matter coming to the auditor's attention that, in his/her judgment, should be communicated because it represents either an opportunity for improvement or a significant deficiency in the design or operation of the internal control structure or in management's ability to operate a program in an effective and efficient manner. |
| SOMCAFR | <i>State of Michigan Comprehensive Annual Financial Report.</i> |