

FINANCIAL AUDIT
INCLUDING THE PROVISIONS OF THE SINGLE AUDIT ACT
OF THE

MICHIGAN STRATEGIC FUND

October 1, 1997 through September 30, 1998

EXECUTIVE DIGEST

MICHIGAN STRATEGIC FUND

INTRODUCTION

This report contains the results of our financial audit* , including the provisions of the Single Audit* Act, of the Michigan Strategic Fund (MSF) for the period October 1, 1997 through September 30, 1998.

AUDIT PURPOSE

This financial audit of MSF was conducted as part of the constitutional responsibility of the Office of the Auditor General to satisfy the requirements of the Single Audit Act Amendments of 1996 and U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

BACKGROUND

MSF was created by Act 270, P.A. 1984 (Sections 125.2001 - 125.2093 of the *Michigan Compiled Laws*), to help diversify the economy of the State and to provide for economic development, primarily by assisting business enterprises to obtain additional sources of financing. Under 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. Subsequent to our audit period, Executive Order 1999-1, effective April 5, 1999, transferred MSF to the Department of Management and

* See glossary at end of report for definition.

Budget as an autonomous entity, created the Department of Career Development, and abolished the Michigan Jobs Commission.

MSF is governed by a nine-member board of directors that consists of the director of the Department of Management and Budget, the State Treasurer, and seven members appointed by the Governor, with the advice and consent of the Senate. The MSF Board of Directors is authorized to make grants, loans, and investments of MSF funds to assist both for-profit and nonprofit businesses.

As of September 30, 1998, MSF had 1 full-time employee and 12 other employees that it shared with the former Michigan Jobs Commission.

AUDIT OBJECTIVES
AND CONCLUSIONS

Audit Objective: To audit MSF's financial statements, including the schedule of expenditures of federal awards, for the fiscal year ended September 30, 1998.

Conclusion: We expressed an unqualified opinion on MSF's financial statements. In addition, we expressed an unqualified opinion on MSF's schedule of expenditures of federal awards.

Audit Objective: To assess and report on MSF's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the financial statements, and on its internal control* over financial reporting, based on our audit of the financial statements.

* See glossary at end of report for definition.

Conclusion: Our assessment of compliance did not disclose any instances of noncompliance that could have a direct and material effect on the financial statements. Also, our assessment of internal control over financial reporting did not disclose any material weaknesses* .

Audit Objective: To assess and report on MSF's compliance with requirements applicable to each major federal program and on its internal control over compliance in accordance with OMB Circular A-133.

Conclusion: Our assessment of compliance applicable to MSF's major federal program did not disclose any instances of noncompliance that are required to be reported in accordance with OMB Circular A-133. Also, our assessment of internal control over compliance applicable to MSF's major federal program did not disclose any material weaknesses.

AUDIT SCOPE

Our audit scope was to examine the financial and other records of the Michigan Strategic Fund for the period October 1, 1997 through September 30, 1998. Our audit was conducted in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

* See glossary at end of report for definition.

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Mr. Doug Rothwell, President
Michigan Strategic Fund
Victor Center
Lansing, Michigan

Dear Mr. Rothwell:

This is our report on the financial audit, including the provisions of the Single Audit Act, of the Michigan Strategic Fund for the period October 1, 1997 through September 30, 1998.

This report contains our executive digest; description of agency; audit objectives and conclusions and audit scope; schedule of findings and questioned costs; and independent auditor's reports on the financial statements, on compliance and on internal control over financial reporting, and on compliance with requirements applicable to each major program and on internal control over compliance in accordance with U.S. Office of Management and Budget Circular A-133. This report also contains the Michigan Strategic Fund financial statements and notes to the financial statements, supplemental financial schedule, other required schedule, and a glossary of acronyms and terms.

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

AUDITOR GENERAL

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Description of Agency

The Michigan Strategic Fund (MSF) was created by Act 270, P.A. 1984 (Sections 125.2001 - 125.2093 of the *Michigan Compiled Laws*), to help diversify the economy of the State and to provide for economic development, primarily by assisting business enterprises to obtain additional sources of financing. Under 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. Subsequent to our audit period, Executive Order 1999-1, effective April 5, 1999, transferred MSF to the Department of Management and Budget as an autonomous entity, created the Department of Career Development, and abolished the Michigan Jobs Commission.

MSF is governed by a nine-member board of directors that consists of the director of the Department of Management and Budget, the State Treasurer, and seven members appointed by the Governor, with the advice and consent of the Senate. The MSF Board of Directors is authorized to make grants, loans, and investments of MSF funds to assist both for-profit and nonprofit businesses.

As of September 30, 1998, MSF had 1 full-time employee and 12 other employees that it shared with the former Michigan Jobs Commission.

Audit Objectives and Conclusions and Audit Scope

Audit Objectives and Conclusions

Our financial audit, including the provisions of the Single Audit Act, of the Michigan Strategic Fund (MSF) had the following objectives:

1. To audit MSF's financial statements, including the schedule of expenditures of federal awards, for the fiscal year ended September 30, 1998.

We expressed an unqualified opinion on MSF's financial statements. In addition, we expressed an unqualified opinion on MSF's schedule of expenditures of federal awards.

2. To assess and report on MSF's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the financial statements, and on its internal control over financial reporting, based on our audit of the financial statements.

Our assessment of compliance did not disclose any instances of noncompliance that could have a direct and material effect on the financial statements. Also, our assessment of internal control over financial reporting did not disclose any material weaknesses.

3. To assess and report on MSF's compliance with requirements applicable to each major federal program and on its internal control over compliance in accordance with U.S. Office of Management and Budget (OMB) Circular A-133.

Our assessment of compliance applicable to MSF's major federal program did not disclose any instances of noncompliance that are required to be reported in accordance with OMB Circular A-133. Also, our assessment of internal control over compliance applicable to MSF's major federal program did not disclose any material weaknesses.

Audit Scope

Our audit scope was to examine the financial and other records of the Michigan Strategic Fund for the period October 1, 1997 through September 30, 1998. Our audit was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *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.

We considered MSF's internal control over compliance applicable to each major federal program and assessed MSF's compliance with federal laws and regulations in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, in addition to generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. MSF's major federal program is identified in Section I of the schedule of findings and questioned costs* .

* See glossary at end of report for definition.

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Section I: Summary of Auditor's Results

Financial Statements

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

Federal Awards

Internal control over major programs:	
Material weaknesses identified?	No
Reportable conditions identified that are not considered to be material weaknesses?	None reported
Type of auditor's report issued on compliance for major programs:	Unqualified
Any audit findings disclosed that are required to be reported in accordance with U.S. Office of Management and Budget (OMB) Circular A-133, Section 510(a)?	
	No

Identification of major programs:

<i>CFDA</i> Number	Name of Federal Program
11.611	Manufacturing Extension Partnership

Dollar threshold used to distinguish between type A and type B programs: \$300,000

Auditee qualified as a low-risk auditee* ? No

Section II: Findings Related to the Financial Statements

We did not report any audit findings.

Section III: Findings and Questioned Costs Related to Federal Awards

We did not report any audit findings.

* See glossary at end of report for definition.

Independent Auditor's Report on
the Financial Statements

March 14, 2000

Mr. Doug Rothwell, President
Michigan Strategic Fund
Victor Center
Lansing, Michigan

Dear Mr. Rothwell:

We have audited the accompanying balance sheet of the Michigan Strategic Fund as of September 30, 1998 and the related statement of revenues, expenses, and changes in retained earnings and statement of cash flows for the fiscal year then ended. These financial statements are the responsibility of the Michigan Strategic Fund management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Michigan Strategic Fund as of and for the fiscal year ended September 30, 1997 were audited by other auditors whose report, dated November 26, 1997, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards 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 discussed in Note 1b, the accompanying financial statements present only the Michigan Strategic Fund and are not intended to present fairly the financial position and results of operations and cash flows of the State of Michigan or its component unit proprietary funds.

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, 1998 and the results of its operations and cash flows for the fiscal year then ended in conformity with generally accepted accounting principles. We also audited the adjustment described in Note 9b(2) that was applied to restate the financial statements for the fiscal year ended September 30, 1997. In our opinion, such an adjustment was appropriate and has been properly applied.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 14, 2000 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 grants.

The accompanying schedule of expenditures of federal awards, required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is presented for purposes of additional analysis and is not a required part of the Michigan Strategic Fund's financial statements referred to in the first paragraph.

Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

AUDITOR GENERAL

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

March 14, 2000

Mr. Doug Rothwell, President
Michigan Strategic Fund
Victor Center
Lansing, Michigan

Dear Mr. Rothwell:

We have audited the financial statements of the Michigan Strategic Fund as of and for the fiscal year ended September 30, 1998 and have issued our report thereon dated March 14, 2000. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

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

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Michigan Strategic Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a 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

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.

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

AUDITOR GENERAL

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

March 14, 2000

Mr. Doug Rothwell, President
Michigan Strategic Fund
Victor Center
Lansing, Michigan

Dear Mr. Rothwell:

Compliance

We have audited the compliance of the Michigan Strategic Fund with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to each major federal program for the fiscal year ended September 30, 1998. The Michigan Strategic Fund's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each major federal program is the responsibility of the Michigan Strategic Fund's management. Our responsibility is to express an opinion on the Michigan Strategic Fund's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to in the previous paragraph that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Michigan Strategic Fund's compliance with those

requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the Michigan Strategic Fund's compliance with those requirements.

In our opinion, the Michigan Strategic Fund complied, in all material respects, with the requirements referred to in the second previous paragraph that are applicable to each major federal program for the fiscal year ended September 30, 1998.

Internal Control Over Compliance

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

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

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

AUDITOR GENERAL

MICHIGAN STRATEGIC FUND

Balance Sheet

As of September 30, 1998

ASSETS

Current Assets:

Cash (Note 2)	\$ 1,572,711
Accounts receivable (Note 4)	25,174,749
Grant receivable	690,151
Marketable securities (Note 2)	17,020,254
Accrued interest receivable	562,933
Current portion of loans receivable (Note 5)	<u>1,673,715</u>
Total Current Assets	<u>\$ 46,694,513</u>

Noncurrent Assets:

Long-term portion of loans receivable (Note 5)	\$ 12,791,134
BIDCO and other investments (Note 1d)	<u>8,934,908</u>
Total Noncurrent Assets	<u>\$ 21,726,042</u>

Restricted Assets:

Cash (Notes 2 and 8)	\$ 14,339,251
Accrued interest receivable	67,596
Marketable securities (Note 2)	101,925,062
Nonmarketable securities	<u>1,807,504</u>
Total Restricted Assets	<u>\$ 118,139,413</u>

Total Assets \$ 186,559,968

LIABILITIES AND FUND EQUITY

Current Liabilities:

Due to Michigan Jobs Commission	\$ 13,463
Grant payable	<u>690,151</u>
Total Current Liabilities	<u>\$ 703,614</u>

Long-Term Liabilities:

Compensated absences (Note 1)	\$ 124,257
Deferred liability - Capital Access Program (Note 8)	14,348,764
Contingent liabilities	<u>2,348</u>
Total Long-Term Liabilities (Note 9)	<u>\$ 14,475,369</u>

Total Liabilities \$ 15,178,983

Fund Equity:

Retained earnings	
Reserved:	
Reserved for commitments (Notes 6 and 9)	\$ 98,403,202
Unreserved (Note 9):	
Designated (Note 6)	12,004,944
Undesignated	<u>60,972,839</u>
Total Fund Equity	<u>\$ 171,380,985</u>

Total Liabilities and Fund Equity \$ 186,559,968

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

MICHIGAN STRATEGIC FUND
Statement of Revenues, Expenses, and
Changes in Retained Earnings
For the Fiscal Year Ended September 30, 1998

OPERATING REVENUES	
Investment earnings	\$ 6,825,623
Net increase (decrease) in fair value of investments	(91,762)
Interest income on loans	1,353,869
Bond application and issuance fees	<u>1,060,405</u>
Total Operating Revenues	<u>\$ 9,148,135</u>
OPERATING AND OTHER EXPENSES	
Salaries, wages, and other administrative expenses	\$ 656,700
Capital Access Program (Note 8)	1,990,270
Loan loss expense	2,128,361
BIDCO principal credits	
Total Operating and Other Expenses	<u>\$ 4,775,331</u>
Operating Income (Loss)	<u>\$ 4,372,804</u>
NONOPERATING REVENUES (EXPENSES)	
Transfer in - General Fund (Note 3)	\$ 586,102
Technology Center grant - National Institute of Standards and Technology	1,968,081
Indian tribal gaming revenue (Notes 9 and 10)	47,876,003
Transfer out - Michigan Jobs Commission (Note 3)	(13,463)
Research Center grants	(9,690,024)
MERRA grants	(770,000)
Consultant contracts	(57,535)
Center for Virtual Learning	(3,630,617)
City of Detroit Downtown Development Authority grant	(6,658,188)
Center for Michigan's Renaissance	(2,985,682)
Center for Career Training	(89,808)
Renaissance zones	<u>(2,037,923)</u>
Total Nonoperating Revenues (Expenses)	<u>\$ 24,496,946</u>
Net Income (Loss)	\$ 28,869,750
Retained Earnings - Beginning of fiscal year - restated (Note 9b(2))	<u>142,511,235</u>
Retained Earnings - End of fiscal year	<u>\$ 171,380,985</u>

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

MICHIGAN STRATEGIC FUND
Statement of Cash Flows
For the Fiscal Year Ended September 30, 1998

CASH FLOWS FROM OPERATING ACTIVITIES	
Operating income (loss)	\$ 4,372,804
Adjustments to reconcile operating activities to net cash provided by (used in) operating activities:	
Investment revenue	(6,825,623)
Changes in assets and liabilities:	
Loans receivable	2,909,104
Accounts receivable	(4,968,345)
Grant receivable	318,478
Due to Michigan Jobs Commission	(13,805)
Grant payable	(318,478)
Decline in fair market value of investments	59,262
Deferred liability	418,103
Contingent liabilities	<u>1,576,410</u>
Net cash provided by (used in) operating activities (Note 9)	<u>\$ (2,472,090)</u>
CASH FLOWS FROM FINANCING ACTIVITIES	
Transfer in - General Fund	\$ 586,102
Transfer out - Michigan Jobs Commission	(13,463)
Indian tribal gaming revenue	47,876,003
Federal grants received	1,968,081
Grant expense	(1,968,081)
Nonoperating expenses	<u>(23,951,696)</u>
Net cash provided by (used in) financing activities (Note 9)	<u>\$ 24,496,946</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Investment revenue	\$ 6,943,866
Purchases of investments	(258,987,920)
Sales and maturities of investments	<u>230,683,609</u>
Net cash provided by (used in) investing activities	<u>\$ (21,360,445)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	\$ 664,411
Cash and cash equivalents at beginning of year	<u>15,247,551</u>
Cash and cash equivalents at end of year	<u>\$ 15,911,962</u>

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

Notes to the Financial Statements

Note 1 Summary of Significant Accounting Policies

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

a. Reporting Entity

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

MSF is considered to be a proprietary 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. Basis of Presentation

(1) 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 operations are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues, and expenses. Government resources are allocated to and accounted for in

separate funds, based upon the purposes for which they are to be spent and the means by which spending activities are controlled.

MSF is accounted for as a proprietary fund. The accompanying financial statements present only the Michigan Strategic Fund and are not intended to present fairly the financial position and results of operations and cash flows of the State of Michigan or its component unit proprietary funds.

- (2) Proprietary Funds: Proprietary funds are accounted for on a flow of economic resources measurement focus. The accounting objectives are a determination of net income, financial position, and cash flow. All assets and liabilities associated with proprietary fund activities are included on the balance sheet.

Proprietary funds are used to account for operations that are financed and operated in a manner similar to private business enterprises, i.e., where the intent of the governing body is that the costs (expenses) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges or where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

c. Measurement Focus/Basis of Accounting

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

Proprietary fund types are accounted for on an economic resources measurement focus using the accrual basis of accounting. Revenues are recorded when they are earned. Expenses are recorded at the time liabilities are incurred.

d. Investments

Equity investments in business and industrial development corporations (BIDCO) are carried at the lower of aggregate cost or fair value. MSF has determined that cost will be used to approximate fair value.

Other equity investments are carried at fair value.

e. Compensated Absences

Accumulated compensated absence pay is accrued when incurred in proprietary funds (using the accrual basis of accounting). At September 30, 1998, the accumulated liability was estimated to be approximately \$124,257.

Note 2 Deposits and Investments

a. General Information

MSF's deposits and investments reported on the balance sheet at September 30, 1998 were made up of the following:

	Cash	Marketable Securities
Deposits	\$15,911,962	\$
Investments		118,945,316
Total	<u>\$15,911,962</u>	<u>\$118,945,316</u>

GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, requires certain disclosures regarding policies and practices with respect to deposits and investments and the custodial credit risk associated with them.

b. Deposits

GASB Statement No. 3 requires that deposits be classified into three categories of credit risk as follows:

Category 1: Insured or collateralized with securities held by the entity or by its agent in the entity's name.

Category 2: Collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name.

Category 3: Uncollateralized, including bank balances that are collateralized with securities held by the pledging financial institution or by its trust department or agent, but not in the entity's name.

Deposits reflected in MSF's bank accounts (without recognition of outstanding checks or deposits in transit) were \$16,772,776 at September 30, 1998. Of that amount, \$2,964,086 was covered by federal depository insurance and was classified in GASB credit risk category 1. The remaining \$13,808,690 was uninsured and uncollateralized at September 30, 1998 and was classified in GASB credit risk category 3.

c. Investments

MSF's policy is to invest in the following investment types:

- (1) Securities issued or guaranteed by the U.S. government or its agencies.
- (2) Repurchase agreements fully collateralized by U.S. government securities.
- (3) Corporate and bank debt including, but not limited to, commercial paper, certificates of deposit, banker's acceptances, and other short-term obligations.

- (4) Corporate notes and bonds.
- (5) Taxable bond funds.
- (6) Money market mutual fund shares which offer daily purchase and redemption and maintain a constant share price.

GASB Statement No. 3 requires that investments be classified into three categories of credit risk as follows:

Category 1: Investments that are insured or registered or for which the securities are held by the entity or its agent in the entity's name.

Category 2: Uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the entity's name.

Category 3: Uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent not in the entity's name.

The following table shows the fair value of investments, by investment type, GASB Statement No. 3 risk category, and in total, at September 30, 1998:

Investment Type	GASB Risk Category			Not Categorized	Fair Value
	1	2	3		
Corporate securities			\$10,140,398	\$	\$ 10,140,398
U.S. government securities			10,313,508		10,313,508
Government money market funds				98,049,815	98,049,815
Equity funds				441,595	441,595
Total Investments	\$ 0	\$ 0	\$20,453,906	\$98,491,410	\$118,945,316

Note 3 Transfers

Transfers out to the Michigan Jobs Commission in the amount of \$13,463 were made during the fiscal year ended September 30, 1998.

The State of Michigan General Fund transferred in \$586,102 for MSF administrative costs for the fiscal year ended September 30, 1998.

Note 4 Accounts Receivable - Casino Revenue

MSF accounts receivable amounted to \$25,174,749 at September 30, 1998. This balance consisted of Indian tribal gaming revenue due to, but not yet received by, MSF.

The revenue is due from seven American Indian tribes located throughout Michigan who are required to contribute an 8% share of their net revenues derived from class III electronic games to MSF. They contribute these collections on a semi-annual basis.

Note 5 Loans Receivable

Loans receivable consisted of the following at September 30, 1998:

Michigan Economic Development Authority (MEDA) and Inducement Loan Program	\$ 2,278,345
Seed	7,800,000
BIDCO	13,662,174
Other	17,541,692
Total	<u>\$ 41,282,211</u>
Less: Allowance for uncollectible loans	(5,500,000)
Loans to be converted to grants	<u>(21,317,362)</u>
Total Loans Receivable	<u><u>\$ 14,464,849</u></u>

MEDA, a predecessor entity to MSF, issued and approved loans for private development.

The MEDA loans are collateralized, for qualifying projects on the basis of participating up to 50% with other public or private lenders. The loans are due under varying repayment terms, including interest at predominantly 9.5% per annum.

Inducement loans are collateralized loans bearing interest at predominantly 5% per annum with varying repayment terms.

Seed capital loans are uncollateralized, 10-year term loans bearing interest at 9% per annum with a balloon payback required at the end of the loan period.

BIDCO and other loans are collateralized loans bearing varying rates of interest and repayment terms.

The current portion of loans receivable includes those payments expected to be received during the next fiscal year.

MSF provided an allowance of \$21,317,362 at September 30, 1998 for loans receivable that MSF expected to be converted to grants. The loans generally provide for no principal or interest payments during the term of the loans. These loans are expected to be converted to grants at the end of their term provided that certain conditions are met by the borrowers. The conditions generally require the borrowers to continue to conduct their principal business activities in the State of Michigan and submit specified reports to MSF.

Note 6 Retained Earnings - Reserved and Designated

MSF reserved retained earnings at September 30, 1998 included \$77.7 million for outstanding grant and other non-loan commitments, \$14.3 million for capital access programs, and \$6.4 million for loan and investment commitments. Outstanding grant and other non-loan commitments included projects such as \$23.3 million to the City of Detroit Downtown Development Authority to support construction of a baseball stadium for the Detroit Tigers, \$28.9 million to the Center for Virtual Learning, \$19.9 million to the Center for Career Training, \$3.7 million to Centers of Excellence, and \$1.6 million to the Center for Michigan's Renaissance.

MSF's Board of Directors has designated retained earnings in the amount of \$12,004,944 as of September 30, 1998 for other projects to promote economic development and job creation within the State of Michigan.

Note 7 Bond Programs

MSF and a predecessor entity (the Michigan Job Development Authority) issued Industrial Development Revenue Bonds. 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 were issued, all financial activity was assumed by a trustee, depository, or paying agent. Accordingly, these obligations are not reported in the MSF financial statements. Information regarding the status of such bond issues, including possible default, must be obtained from the trustee or depository for bonds, the industrial or commercial enterprise benefited by the bonds, or some other knowledgeable source.

The total amount of Industrial Development Revenue Bonds issued by MSF and its predecessor entity for the period January 1, 1979 through September 30, 1998 was \$4,252,016,280. The total amount of Taxable Bond Program bonds issued by MSF for the period October 1, 1997 through September 30, 1998 was \$18,000,000.

Note 8 Capital Access Program

MSF established the Capital Access Program in 1986 to encourage participating banks to make business loans that are riskier than conventional loans.

A participating bank establishes a special account under MSF's name at the bank to cover future losses from a portfolio of loans that the bank makes under the program. Contributions to this account are made by MSF, the bank, and a borrower. For each loan that the bank makes, the bank and borrower each contributes from 1.5% to 3% of the loan amount to the account and MSF matches this amount. MSF owns all the contributions to this account. However, MSF cannot withdraw and use these funds for another purpose unless the bank drops out of the program and all loans previously made have been paid off. Thus, these funds may remain at a participating bank in perpetuity. MSF's loan loss liability under the program is limited to the total amount of funds held in this account.

As a result, the amount reported on MSF's balance sheet as "Deferred liability - Capital Access Program" should approximately equal the amount reported as "Cash" under restricted assets, which is the total amount of funds being held in special accounts by all participating banks in the program.

In addition, MSF immediately expenses its contributions to the special accounts when banks approve new loans under the program.

Note 9 Accounting Restatements

On September 17, 1999, MSF received approval from the Office of Financial Management, Department of Management and Budget, to present corrected MSF financial statements and schedules for the fiscal year ended September 30, 1998.

The impact of this approval is that the financial statements presented in this report differ from those previously reported in the *State of Michigan Comprehensive Annual Financial Report* by the following:

a. Balance Sheet

- (1) Long-term liabilities were decreased by \$8,121,611 from a reported \$22,596,980 to \$14,475,369.
- (2) Reserved retained earnings were increased by \$5,653,820 from a reported \$92,749,382 to \$98,403,202.
- (3) Unreserved retained earnings, which consist of designated and undesignated retained earnings, were increased by \$2,467,791 from a reported \$70,509,992 to \$72,977,783.

b. Statement of Revenues, Expenses, and Changes in Retained Earnings

- (1) Indian tribal gaming revenue was increased by \$3,356,576 from a reported \$44,519,427 to \$47,876,003.
- (2) Retained earnings - beginning of fiscal year were increased by \$4,765,035 from a reported \$137,746,200 to \$142,511,235 to recognize Indian tribal gaming revenue earned in fiscal year 1996-97 and prior fiscal years.

c. Statement of Cash Flows

- (1) Net cash provided by (used in) operating activities was decreased by \$3,356,576 from a reported \$884,486 to (\$2,472,090).
- (2) Net cash provided by (used in) financing activities was increased by \$3,356,576 from a reported \$21,140,370 to \$24,496,946.

Note 10 Subsequent Events

a. Indian Tribe Casinos

MSF's major revenue source is its 8% share of the net revenues derived from the class III electronic games of several casinos operated by American Indian Tribes in Michigan. MSF has received money from this source since March 1994. During the fiscal year ended September 30, 1998, revenue was recognized from the seven tribes operating such casinos in the amount of \$47,876,003. This amount represented approximately 80% of total revenues and transfers in for the fiscal year ended September 30, 1998.

An initiative approved by Michigan voters in the November 1996 election allowing up to three casinos to operate in Detroit had the apparent effect of violating the condition for continued payment by the seven tribes of these revenues to MSF. There was a difference of opinion as to the timing of such violations.

On December 9, 1996, the State filed a motion to force the tribes to comply with the 1993 consent judgment. A hearing on this motion was held on February 3, 1997, and it was determined that the tribes were required to continue payments to MSF until the Detroit casinos became officially licensed. The first such casino became licensed on July 29, 1999.

On December 11, 1998, the State approved four additional tribes' casinos, one of which was operating as of February 1, 2000. These tribes are required to make payments to MSF for its 8% share of the net revenues from class III electronic games regardless of the status of the Detroit casinos.

Two of the seven original tribes contend that their obligation to the State ceased as of February 18, 1999 when the U.S. Secretary of the Interior approved tribal-State compacts concluded with each of the four new tribes. On July 22, 1999, the State again filed a motion in the U.S. District Court to force these two tribes to comply with the 1993 consent judgment. On February 28, 2000, the U.S. District Court ruled in the two tribes' favor. On March 14, 2000, the State filed a notice of appeal of this decision with the U.S. Court of Appeals.

Three of the five other tribal parties to the 1993 compacts reached an agreed-upon date of June 30, 1999 for termination of the payment obligation. The other two tribes continue to negotiate with the State.

On June 10, 1999, a lawsuit was filed in the Ingham County Circuit Court. The lawsuit contends that the State's approval of the four additional tribal compacts did not agree with State law. On January 18, 2000, the Circuit Court ruled in the plaintiffs' favor. On February 4, 2000, the State filed an appeal of this decision with the Michigan Court of Appeals.

b. Executive Orders

On February 3, 1999, the Governor signed Executive Order 1999-1, effective April 5, 1999, which transferred MSF to the Department of Management and Budget as an autonomous agency. The Order also transferred the following economic development and other programs and functions within State government to MSF:

- Michigan Economic Growth Authority
- Plant Rehabilitation and Industrial Development Districts
- State Education Tax Exclusion
- Personal Property Tax Exemption
- Community Development Block Grants
- Economic Development Job Training
- Department of Economic Expansion and the Economic Expansion Council
- Michigan International Trade Authority
- Michigan Enterprise Zone Authority

Neighborhood Enterprise Zones
Michigan Urban Land Assembly Act
Michigan Travel Commission
Travel Michigan
Office of the Michigan Business Ombudsman
Office of the Small Business Clean Air Ombudsman
Michigan Renaissance Zone Act
Michigan Business Incubation Act
Commercial Redevelopment Act
Economic Development Corporations Act
Office of Film and Television Services
Operator and chauffeur license fees
Michigan Training Incentive Fund
Minority, Women and Small Business Services units
Capital Resources Group
Office of Business and Education Coordination
Sales Unit of the Development Services Division
K.I. Sawyer Conversion Authority
Wurtsmith Conversion Authority

Executive Order 1999-1 also provided that MSF had the authority to enter into an interlocal agreement with local public agencies to create the Michigan Economic Development Corporation (MEDC) as a new public entity to help administer any programs transferred to MSF. The Order further provided that any economic development programs transferred to MSF could be transferred, along with the relevant personnel and funding, to the new MEDC.

On March 29, 1999, the MSF Board of Directors approved and the MSF president entered into an interlocal agreement with the Economic Development Corporation of the Charter County of Wayne creating MEDC to jointly exercise economic development powers with MSF. This agreement became effective April 5, 1999.

On April 5, 1999, the MSF Board of Directors passed Resolution 1999-071 transferring the following funding, assets, liabilities, fund equity, and programs to MEDC to carry out the interlocal agreement:

(1) Effective April 5, 1999

- (a) The available balance of all State appropriated funds of the programs transferred to MSF under Executive Order 1999-1 for fiscal year 1999-2000 and subsequent fiscal years, except for federal Community Development Block Grants.
- (b) The functions of the programs transferred to MSF under Executive Order 1999-1, except for the functions related to operator and chauffeur license fees.
- (c) Bond application and issuance fees received within 14 days of the beginning of the month following their receipt by MSF, except for the first \$50,000 received annually.
- (d) A start up advance of \$500,000.

(2) Effective May 1, 1999

- (a) Net assets (assets less liabilities) totaling \$162,713,480.
- (b) All subsequent cash received from Indian tribes and other revenue sources within 14 days of the beginning of the month following their receipt by MSF.

On March 11, 1999, the Governor also signed Executive Order 1992-2, effective May 10, 1999, that rescinded the transfer stipulated in Executive Order 1999-1 of programs related to operator and chauffeur license fees. Also, the Order transferred the functions of the State Transportation Commission related to economic development road projects to the director of the Michigan Department of Transportation and to the MSF president, jointly.

SUPPLEMENTAL FINANCIAL SCHEDULE

MICHIGAN STRATEGIC FUND
Schedule of Expenditures of Federal Awards *
For the Fiscal Year Ended September 30, 1998

<u>Federal Agency/Program</u>	<u>CFDA **</u> <u>Number</u>	<u>Pass-Through</u> <u>Identification</u> <u>Number</u>	<u>Directly</u> <u>Expended</u>	<u>Distributed to</u> <u>Subrecipient</u>	<u>Total Expended</u> <u>and Distributed</u>
<u>U.S. Department of Commerce</u>					
Manufacturing Extension Partnership	11.611		<u>\$ 0</u>	<u>\$ 1,968,080</u>	<u>\$ 1,968,080</u>
Total U.S. Department of Commerce			<u>\$ 0</u>	<u>\$ 1,968,080</u>	<u>\$ 1,968,080</u>
Total Expenditures of Federal Awards			<u>\$ 0</u>	<u>\$ 1,968,080</u>	<u>\$ 1,968,080</u>

* Basis of Presentation: This schedule includes the federal grant activity of the Michigan Strategic Fund and is presented on the modified accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the financial statements.

** CFDA is defined as *Catalog of Federal Domestic Assistance*.

OTHER REQUIRED SCHEDULE

MICHIGAN STRATEGIC FUND
Summary Schedule of Prior Audit Findings
As of March 14, 2000

No audit findings were reported for fiscal years 1995-96 and 1996-97.

Glossary of Acronyms and Terms

BIDCO	business and industrial development corporations.
CFDA	<i>Catalog of Federal Domestic Assistance.</i>
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.
GASB	Governmental Accounting Standards Board.
internal control	A process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.
low-risk auditee	As provided for in OMB Circular A-133, an auditee that may qualify for reduced federal coverage if it receives an annual Single Audit and it meets other criteria related to prior audit results.
material weakness	A 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 either misstatements in amounts that would be material in relation to the financial statements being audited or noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program

being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

MEDA	Michigan Economic Development Authority.
MEDC	Michigan Economic Development Corporation.
MSF	Michigan Strategic Fund.
OMB	U.S. Office of Management and Budget.
questioned costs	Costs tentatively identified as unallowable, undocumented, unapproved, or unreasonable. These costs are subject to disallowance by the federal government.
Single Audit	A financial audit, performed in accordance with the Single Audit Act Amendments of 1996, that is designed to meet the needs of all federal grantor agencies and other financial report users. In addition to performing the audit in accordance with the requirements of generally accepted auditing standards and the standards applicable to financial audits contained in <i>Government Auditing Standards</i> issued by the Comptroller General of the United States, a Single Audit requires the assessment of compliance with requirements that could have a direct and material effect on a major federal program and the consideration of internal control over compliance in accordance with OMB Circular A-133.