

Audited Financial Statements

State of Michigan
Talent Investment Agency
Unemployment Insurance Agency –
Contingent Fund

*Year Ended September 30, 2016
with Report of Independent Auditors*

State of Michigan
Talent Investment Agency
Unemployment Insurance Agency –
Contingent Fund

Audited Financial Statements

Year Ended September 30, 2016

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Report of Independent Auditors

State of Michigan
Office of the Auditor General,
Office of Financial Management, and
Talent Investment Agency,
Unemployment Insurance Agency

Report on the Financial Statements

We have audited the accompanying financial statements of the Contingent Fund of the State of Michigan Talent Investment Agency, Unemployment Insurance Agency as of and for the year ended September 30, 2016, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of September 30, 2016, and the changes in financial position and cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1, the financial statements present only the Contingent Fund of the State of Michigan Talent Investment Agency, Unemployment Insurance Agency and do not purport to, and do not, present fairly the financial position of the State of Michigan or the State of Michigan Talent Investment Agency, Unemployment Insurance Agency in its entirety as of September 30, 2016, the changes in its financial position, or, where applicable, cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

As discussed in Note 6 to the financial statements, certain errors resulting in understatement of amounts previously recorded for revenue and receivable from claimants as of September 30, 2015, were discovered by management of the Fund during the current year. Accordingly, an adjustment has been made to net position as of September 30, 2015, to correct the error. Our opinion is not modified with respect to that matter.

Other Matter

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that management's discussion and analysis be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 5, 2016, on our consideration of the Contingent Fund of the State of Michigan Talent Investment Agency, Unemployment Insurance Agency's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of

internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Contingent Fund of the State of Michigan Talent Investment Agency, Unemployment Insurance Agency's internal control over financial reporting and compliance.

Andrews Hooper Pavlik PLC

Auburn Hills, Michigan
December 5, 2016

State of Michigan
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Management's Discussion and Analysis

Year ended September 30, 2016

Our discussion and analysis of the Contingent Fund of the State of Michigan Talent Investment Agency, Unemployment Insurance Agency's (Fund) enterprise fund financial performance provides an overview of the Fund's activities for the year ended September 30, 2016.

The Fund was established under the provisions of the Michigan Employment Security Act of 1936 to account for collections of interest and penalties on delinquent unemployment contributions from employers, misrepresentation penalties on wrongfully collected unemployment benefits from claimants, and a special unemployment tax surcharge imposed on certain employers known as Solvency Tax. The accompanying financial statements present the results of operations for the Fund only. Accordingly, these financial statements do not present fairly the financial position or results of operations of the State of Michigan or the State of Michigan Talent Investment Agency, Unemployment Insurance Agency.

Financial Highlights

- Net position increased by \$42,935,377. Penalty and interest collections increased by almost 20% this year primarily attributed to improved collection efforts.
- In Fiscal Year 2016, the Agency received clarification from USDOL-ETA regarding the allocation of penalty and interest collections attributable to federal programs. The clarification received stipulated that the recoveries of penalties and interest assessed on overpayments attributable to federal programs are treated differently. Collections associated with interest assessments on overpayments must be returned to the federal program; however penalties collected are to be used at the discretion of the state. The MES Act stipulates the deposit of all penalty collections into the Contingent Fund.

Upon receipt of the federal guidance, the agency performed a prior year adjustment in order to recognize the allocation of the federal penalties previously collected. This resulted in a prior period adjustment total of \$18,491,067 to the Contingent Fund.

Using this Annual Financial Report

The annual report includes this management's discussion and analysis report, the independent auditors' report, and the financial statements of the Fund. The financial statements also include notes that explain in more detail some of the information in the financial statements.

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Management’s Discussion and Analysis

Year ended September 30, 2016

Financial Reporting

The Statement of Net Position presents information on all of the Fund’s assets and liabilities, with the difference between the two reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the Fund is improving or deteriorating. However, one will need to consider other nonfinancial factors such as changes in economic conditions, population growth, and new or changed government legislation.

The Statement of Revenues, Expenses, and Changes in Net Position presents information showing how the Fund’s net position changed during the most recent fiscal year. All changes in net position are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods.

Reporting on the Fund

Fund financial statements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Fund, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Notes to financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the financial statements.

Financial Analysis of the Fund

Exhibit A provides the comparative summary of the Fund’s net position as of September 30, 2016 and 2015:

Exhibit A

	2016 (In Thousands)	2015 (restated) (In Thousands)
Assets		
Total assets (all current)	<u>\$ 211,032</u>	<u>\$ 168,097</u>
Liabilities		
Total liabilities (all current)	<u>-</u>	<u>-</u>
Net position		
Total net position (all restricted)	<u>\$ 211,032</u>	<u>\$ 168,097</u>

The most significant change in assets for 2016 was the increase in Equity in Common Cash. The increase is primarily attributable to the new allocation of federal penalty collections to the Contingent Fund.

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Management’s Discussion and Analysis

Year ended September 30, 2016

The results of this year’s operations for the Fund are reported in the Statement of Revenues, Expenses, and Changes in Net Position, as summarized in Exhibit B below, which shows the changes in net position for the years ended September 30, 2016 and 2015.

Exhibit B

	2016 (In Thousands)	2015 (restated) (In Thousands)
Revenues		
Operating	\$ 54,056	\$ 50,464
Nonoperating	451	91
Total revenues	54,507	50,555
 Expenses		
Operating	17	13
Total expenses	17	13
 Income before transfers	 54,490	 50,542
Transfers out	(11,555)	(1,087)
Change in net position	\$ 42,935	\$ 49,455

Operating revenues increased in 2016 due to an increase in both employer and claimant penalty collections. The increase in transfers out is attributable to the appropriation of funds to support training programs for unemployed workers.

Factors Expected to Have an Effect on Future Operations

The allocation of federal penalties will provide additional revenue to the Contingent Fund going forward. However, unemployment claims in the State of Michigan have been historically low and are expected to remain so in the short term. This low unemployment, coupled with new program integrity measures implemented by the UIA, will result in fewer overpayment claims and a reduction in claimant receivables.

Lower employer receivables balances are expected to continue due to the incentive of a reduced wage base, \$9,000 compared to \$9,500, for employers that are not delinquent in their taxes, generating lower penalties and interest.

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Statement of Net Position

September 30, 2016

Assets

Current assets:

Equity in State of Michigan Treasurer's common cash	\$ 159,917,028
Receivable from contributing employers	27,770,162
Receivable from claimants	21,532,512
Due from State of Michigan funds	<u>1,812,398</u>
Total assets	<u>211,032,100</u>

Liabilities

Current liabilities:

Due to State of Michigan funds	<u>-</u>
Total liabilities	-

Net Position

Restricted	<u>211,032,100</u>
Total net position	<u><u>\$ 211,032,100</u></u>

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Statement of Revenues, Expenses, and Changes in Net Position

Year Ended September 30, 2016

Operating revenues:	
Interest and penalties on delinquent unemployment contributions	\$ 29,427,350
Interest and penalties on claimant overpayments	24,629,074
Total operating revenues	<u>54,056,424</u>
Operating expenses:	
Other expenses	5,979
Other fees	11,400
Total operating expenses	<u>17,379</u>
Operating income	<u>54,039,045</u>
Nonoperating revenues and expenses:	
Interest earned	<u>451,648</u>
Income before transfers	54,490,693
Transfers out	<u>(11,555,316)</u>
Change in net position	42,935,377
Total net position at beginning of year	149,605,656
Prior period adjustment	18,491,067
Total net position at beginning of year, as restated	<u>168,096,723</u>
Total net position at end of year	<u><u>\$ 211,032,100</u></u>

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Statement of Cash Flows

Year Ended September 30, 2016

Cash flows from operating activities:	
Cash received from solvency collections	\$ 60,519
Cash received from interest and penalties on delinquent unemployment contributions	28,497,486
Cash received from interest and penalties on claimant overpayments	31,966,151
Payments of other fees	<u>(11,400)</u>
Net cash provided by operating activities	60,512,756
Cash flows from noncapital financing activities:	
Transfers out	<u>(11,555,316)</u>
Net cash used in noncapital financing activities	(11,555,316)
Cash flows from investing activities:	
Interest earned	<u>451,648</u>
Net cash provided by investing activities	<u>451,648</u>
Net increase in cash	49,409,088
Cash at beginning of the year	<u>110,507,940</u>
Cash at end of the year	<u><u>\$ 159,917,028</u></u>
Reconciliation of operating income to net cash provided by operating activities:	
Operating income	\$ 54,039,045
Net changes in assets and liabilities:	
Receivable from claimant overpayments	7,337,077
Receivable from contributing employers	(929,864)
Due from State of Michigan funds	<u>66,498</u>
Net cash provided by operating activities	<u><u>\$ 60,512,756</u></u>

See accompanying notes.

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Notes to Financial Statements

September 30, 2016

1. General Activities and Significant Accounting Policies

The Contingent Fund of the State of Michigan Talent Investment Agency, Unemployment Insurance Agency (Fund) was established under the provisions of the Michigan Employment Security Act of 1936. The financial statements of the Fund have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) as applied to governmental units. The Governmental Accounting Standards Board (GASB) is the standard-setting body for governmental accounting and financial reporting.

The Fund accounts for collections of interest and penalties on delinquent unemployment contributions from employers, misrepresentation penalties on wrongfully collected unemployment benefits from claimants, and a special unemployment tax surcharge imposed on certain employers known as Solvency Tax.

The Fund's financial statement amounts are included in the combined financial statements contained in the State of Michigan (State) Comprehensive Annual Financial Report.

Basis of Accounting

The financial statements are prepared using the economic resources measurement focus and the accrual basis of accounting. Under this measurement focus, revenues are recognized when they are earned and expenses are recognized when incurred, regardless of the timing of related cash flows.

Cash

For the purposes of the Statement of Cash Flows, the amount reported as cash and cash equivalents is equal to the amount on the Statement of Net Position classified as Equity in State of Michigan Treasurer's common cash. The State common cash pool consists of highly liquid investments and functions as both a cash management pool and demand deposit account.

Receivables from Contributing Employers

Receivables from contributing employers represent the amount of interest and penalties and solvency tax owed from employers that management has deemed collectible as of September 30, 2016.

Receivables from Claimants

Receivables from claimants represent the amount of misrepresentation penalties and interest owed on wrongfully collected unemployment benefits that management has deemed collectible as of September 30, 2016.

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Notes to Financial Statements

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1. General Activities and Significant Accounting Policies (continued)

Restricted Net Position

Net position is restricted for administration of the Unemployment Insurance Agency funds and for the career development of unemployed individuals that need assistance.

Operating Revenues and Expenses

Operating revenues primarily result from the collection of interest and penalties on delinquent unemployment contributions and misrepresentation penalties on wrongfully collected unemployment benefits. Operating expenses are specifically appropriated by the legislature. Revenues and expenses not meeting these definitions are reported as nonoperating revenues and transfers.

Use of Estimates

The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Deferred Outflows and Inflows of Resources

In addition to assets, the balance sheet will sometimes report a separate section for deferred outflows of resources. This separate financial statement element, deferred outflows of resources, represents a consumption of fund balance that applies to a future period(s) and thus, will not be recognized as an outflow of resources (expense/expenditure) until then. The Fund has no items that qualify for reporting in this category.

In addition to liabilities, the balance sheet will sometimes report a separate section for deferred inflows of resources. This separate financial statement element, deferred inflows of resources, represents an acquisition of fund balance that applies to a future period(s) and so, will not be recognized as an inflow of resources (revenue) until that time. The Fund has no items that qualify for reporting in this category.

2. Equity in State of Michigan Treasurer's Common Cash

Equity in State of Michigan Treasurer's common cash pool represents the Fund's interest, at fair market value, in an investment pool managed by the Treasurer of the State of Michigan. The Fund is credited quarterly with investment earnings and interest based upon average daily balances.

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2. Equity in State of Michigan Treasurer’s Common Cash (continued)

The investment authority for the common cash pool is found in Public Act 105 of 1855, as amended. The State Treasurer may invest surplus funds belonging to the State in the bonds, notes, and other evidences of indebtedness of the United States Government and its agencies; and in prime commercial paper. Certificates of deposit are permitted in financial institutions whose principal office is located in the State.

The Fund’s pro-rata share of the State Treasurer’s common cash pool was \$159,917,028 as of September 30, 2016. For the total amount of deposits and investments in the State Treasurer’s common cash pool and their specific risks, please refer to the State of Michigan Comprehensive Annual Financial Report.

Common Cash Deposits

Custodial Credit Risk

The custodial credit risk for deposits is the risk that, in the event of failure of a depository financial institution, the State’s deposits may not be recovered.

Deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are:

- a. Uncollateralized,
- b. Collateralized with securities held by the pledging financial institution or,
- c. Collateralized with securities held by the pledging financial institution’s trust department or agent but not in the depositor-government’s name.

The State Treasurer’s common cash pool policy requires the following criteria to lessen the custodial credit risk: all financial institutions holding the State’s deposits must pledge collateral equal to the amount of the account balance for all demand and time deposits to secure the State’s funds. A bank, savings and loan association, or credit union holding the State’s deposits must be organized under the laws of the State or federal law and maintain a principal office or branch office in the State. No deposit in any financial organization may be in excess of 50% of the net worth of the organization.

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2. Equity in State of Michigan Treasurer’s Common Cash (continued)

Common Cash Deposits (continued)

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of deposits.

Public Act 35 of 1997 requires State deposits be held in a financial institution which maintains a principal office or branch office located in the State. The State had no common cash pooled deposits subject to foreign currency risk as of September 30, 2016.

Common Cash Investments

Types of Investments

State Treasurer’s common cash pool investments include prime commercial paper, corporate notes, and emergency municipal notes.

Risk

In accordance with GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, investments also require certain disclosures regarding policies and practices with respect to the risks associated with them.

The custodial credit risk, credit risk, interest rate risk, concentration of credit risk, and foreign currency risk are discussed in the following paragraphs.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of a failure by a counterparty, the Fund will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party.

Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government, and are held by either:

The counterparty or,

The counterparty’s trust department or agent but not in the government’s name.

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2. Equity in State of Michigan Treasurer’s Common Cash (continued)

Common Cash Investments (continued)

Custodial Credit Risk (continued)

The State Treasurer’s common cash pool does not have an investment policy for managing custodial credit risk. As of September 30, 2016, the State Treasurer’s common cash pool investments were not exposed to custodial credit risk.

Credit Risk

Credit risk is the risk that an issuer or another counterparty to an investment will not fulfill its obligations.

The State Treasurer’s common cash pool requires prime commercial paper investments be rated A-1 or P-1 at the time of purchase as rated by the two major rating services: Standard and Poor’s (A-1) and Moody’s (P-1). Borrowers must also have at least \$400 million in commercial paper outstanding and the State Treasurer may not invest in more than 10% of a borrower’s outstanding debt. The State Treasurer’s common cash pool investments are further limited to \$200 million in any borrower, unless the borrower has an A-1+ rating, in which case the investment is not to exceed \$300 million.

The State Treasurer’s investment in emergency municipal loans are evidenced by unrated notes held by the State in the State’s name. In addition, at September 30, 2016, prime commercial paper investments were rated at A-1, P-1, or above.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment.

The State Treasurer’s common cash pool policy states that cash equivalents are to be invested in short-term fixed income securities with an average weighted maturity of less than one year to provide liquidity and safety of principal from capital market and default risk.

The State Treasurer does not have a policy for controlling interest rate risk regarding the State Treasurer’s common cash pool investments in special loan programs (Emergency Financial Assistance Loan Program, Michigan Marina Dredging Loan Program, and Agriculture Disaster Relief Program). These loan programs are investments created through legislation. Although some interest rate risk exposure exists, interest rate risk is not a consideration when entering into the special loan programs.

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2. Equity in State of Michigan Treasurer’s Common Cash (continued)

Common Cash Investments (continued)

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of a government’s investments with a single issuer.

The Fund is invested in pooled investments in the State Treasurer’s common cash pool, which is excluded from the concentration of credit risk disclosure requirements.

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of investments.

The State Treasurer’s common cash pool investment policy does not allow for investment in foreign investments or currency; therefore, the Fund is not exposed to foreign currency risk.

3. Transfers

The Fund records expenses to other State agencies for services received as transfers, in accordance with accounting policies established by the State.

4. Risk Management

The State of Michigan has established internal service funds to account for certain aspects of its risk management program. The Fund transfers money to these internal service funds to pay for coverage on these types of risks.

The State of Michigan does not carry commercial insurance for many of the risks of losses to which it is exposed. The State of Michigan is self-insured for most general liability and property losses, portions of its employee insurance benefit and employee bonding programs, automobile liability, and workers’ compensation and unemployment compensation claims. The State of Michigan purchases some level of insurance coverage for portions of the state employee insurance benefits program, boiler and machinery coverage, and employee bonding. Information regarding current year claims and changes in estimates, claim payments, and amount of claims liability is included in the State of Michigan Comprehensive Annual Financial Report.

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5. Contingencies

The Fund is involved in various claims and legal actions. Although it is not possible to predict the outcome of these matters, in the opinion of management, their ultimate disposition will not have a material effect on the financial position of the Fund.

6. Prior Period Adjustment

The beginning net position on the financial statements has been restated to correct for penalty revenues on claimant overpayments of \$18,491,067 not recorded in prior years. Beginning net position of \$149,605,656, as originally reported, has been increased to \$168,096,723. This adjustment had no impact on the current year change in net position.