

Audited Financial Statements

State of Michigan
Department of Talent and Economic Development
Talent Investment Agency –
Contingent Fund

*Year Ended September 30, 2017
with Report of Independent Auditors*

State of Michigan
Department of Talent and Economic Development
Talent Investment Agency –
Contingent Fund

Audited Financial Statements

Year Ended September 30, 2017

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Report of Independent Auditors

State of Michigan
Office of the Auditor General,
Office of Financial Management, and
Talent Investment 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 as of and for the year ended September 30, 2017, 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 Contingent Fund as of September 30, 2017, 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 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 in its entirety as of September 30, 2017, 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.

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 8, 2017, on our consideration of the Contingent Fund of the State of Michigan Talent Investment 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's internal control over financial reporting and compliance.

Andrews Hooper Paulik PLC

Auburn Hills, Michigan
December 8, 2017

State of Michigan
Department of Talent and Economic Development
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Management’s Discussion and Analysis

September 30, 2017

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 Contingent Fund (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 and interest on wrongfully collected unemployment benefits from claimants, and a special unemployment tax surcharge imposed on certain employers known as Solvency Tax. The Fund, like other state and local governmental funds, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

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 Talent Investment Agency.

This annual report includes 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. The notes are essential to a full understanding of the data provided in the financial statements.

Financial Highlights

- The Fund’s net position decreased by \$5.4 million over the last year. Factors contributing to the decline include a one-time legislatively mandated transfer of \$10 million to the General Fund and a comprehensive fraud review project which resulted in a significant number of penalty and interest reimbursements to claimants.
- Operating revenues declined for both employers and claimants. Employer penalties and interest collections have been steadily declining since their peak in 2015. Collection activities on a significant number of claimant overpayments were paused while the agency completed a comprehensive review of fraud determinations made during fiscal years 2014 and 2015.
- The Fund also experienced an increase in transfers out. In addition to the \$10 million general fund transfer, over \$20 million was utilized for various talent investment programs aimed at connecting individuals and businesses with training and support.

Financial Analysis of the Fund

Our analysis provides an overview of the financial performance of the State of Michigan Talent Investment Agency’s Contingent Fund.

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Management’s Discussion and Analysis

September 30, 2017

Financial Analysis of the Fund (continued)

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 and new or changed government legislation.

The net position of the Fund is restricted for certain costs of administration of unemployment compensation programs and employment services.

Exhibit A provides the comparative summary of the Fund’s net position as of September 30, 2017 and 2016:

Exhibit A

	2017	2016
	(In Thousands)	(In Thousands)
Assets		
Total assets (all current)	\$ 205,639	\$ 211,032
Liabilities		
Total liabilities (all current)	-	-
Net position		
Total net position (all restricted)	\$ 205,639	\$ 211,032

The statement of revenues, expenses, and changes in net position present 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.

Exhibit B provides a comparative summary of the changes in net position for the years ended September 30, 2017 and 2016, as reported in the statement of revenues, expenses, and changes in net position.

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Management’s Discussion and Analysis

September 30, 2017

Financial Analysis of the Fund (continued)

Exhibit B

	2017 (In Thousands)	2016 (In Thousands)
Revenues		
Operating	\$ 30,043	\$ 54,056
Nonoperating	1,375	451
Total revenues	31,418	54,507
 Expenses		
Operating	6,098	17
Total expenses	6,098	17
 Income before transfers	25,320	54,490
 Transfers out	(30,714)	(11,555)
Change in net position	\$ (5,394)	\$ 42,935

Factors Expected to Have an Effect on Future Operations

Collection activities on a significant number of claimant overpayments were paused during 2017 while the agency completed a comprehensive review of fraud determinations. Fraud determinations that were not supported upon review were overturned, and any collections assigned to them were reversed and refunded. The reduction in receivables and the refunds issued due to this project had a negative impact on the Fund’s 2017 revenues and receivables. The reduction in receivables will result in lower claimant penalty and interest collections moving forward. However, in 2018 the Fund is expected to show an increase in collections from the 2017 level as collection tools are reactivated.

Employer collections, which historically have generated the majority of the Contingent Fund’s revenue, are expected to continue to decline. Lower tax rates, automated tax payments, and the \$9,000 wage base for non-delinquent employers provide incentives for employers to ensure their reports and payments are timely.

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Statement of Net Position

September 30, 2017

Assets

Current assets:

Equity in State of Michigan Treasurer's common cash	\$ 160,056,117
Receivable from contributing employers	25,288,182
Receivable from claimants	15,551,000
Due from State of Michigan funds	4,743,294
Total assets	<u>205,638,593</u>

Liabilities

Current liabilities:

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

Net Position

Restricted	205,638,593
Total net position	<u><u>\$ 205,638,593</u></u>

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Statement of Revenues, Expenses, and Changes in Net Position

Year Ended September 30, 2017

Operating revenues:	
Interest and penalties on delinquent unemployment contributions	\$ 25,881,704
Interest and penalties on claimant overpayments	4,161,744
Total operating revenues	30,043,448
Operating expenses:	
Claimant reimbursements	5,790,236
Miscellaneous operating expense	285,808
Other fees	21,700
Total operating expenses	6,097,744
Operating income	23,945,704
Nonoperating revenues and expenses:	
Interest earned	1,374,758
Income before transfers	25,320,462
Transfers out	(30,713,969)
Change in net position	(5,393,507)
Total net position at beginning of year	211,032,100
Total net position at end of year	\$ 205,638,593

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Statement of Cash Flows

Year Ended September 30, 2017

Cash flows from operating activities:	
Cash received from interest and penalties on delinquent unemployment contributions	\$ 26,000,000
Cash received from interest and penalties on claimant overpayments	9,290,236
Payments of claimant reimbursements	(5,790,236)
Payments of other fees	<u>(21,700)</u>
Net cash provided by operating activities	29,478,300
Cash flows from noncapital financing activities:	
Transfers out	<u>(30,713,969)</u>
Net cash used in noncapital financing activities	(30,713,969)
Cash flows from investing activities:	
Interest earned	<u>1,374,758</u>
Net cash provided by investing activities	<u>1,374,758</u>
Net increase in cash	139,089
Cash at beginning of the year	<u>159,917,028</u>
Cash at end of the year	<u><u>\$ 160,056,117</u></u>
Reconciliation of operating income to net cash provided by operating activities:	
Operating income	\$ 23,945,704
Net changes in assets and liabilities:	
Receivable from claimant overpayments	5,981,512
Receivable from contributing employers	2,481,980
Due from State of Michigan funds	<u>(2,930,896)</u>
Net cash provided by operating activities	<u><u>\$ 29,478,300</u></u>

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Notes to Financial Statements

September 30, 2017

1. General Activities and Significant Accounting Policies

The Contingent Fund of the State of Michigan Talent Investment 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 and interest 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, 2017.

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, 2017.

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Notes to Financial Statements

September 30, 2017

1. General Activities and Significant Accounting Policies (continued)

Restricted Net Position

Net position is restricted for administration of unemployment insurance provided by State of Michigan Talent Investment 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 and interest 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 thus, 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.

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

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.

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 \$160,056,117 as of September 30, 2017. 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, 2017.

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, 2017, 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, as of September 30, 2017, 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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Notes to Financial Statements

September 30, 2017

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 elected not to purchase 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. Areas of risk where some level of insurance coverage is purchased include: aircraft liability, property and loss rental insurance that may be required by bond or lease agreements, portions of the State employee insurance benefits program, certain State artifacts, builder's risk coverage, boiler and machinery coverage, and employee bonding. Settled claims have not exceeded commercial coverage in any of the past 10 fiscal years.

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4. Risk Management (continued)

The State of Michigan has established two internal service funds to account for certain aspects of the risk management program. Fund expenditures (expenses) are recognized in the paying funds in a manner similar to purchased commercial insurance. For other uninsured losses not covered by an internal service fund program, such as general liability and property losses, the Fund recognizes liabilities and records expenditures when a loss is due and payable.

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. Claimant Reimbursements

During the year, the agency concluded an extensive two-year review project of fraud determinations that were assessed during fiscal years 2014 and 2015. The agency used a comprehensive process and included quality assurance measures to ensure accuracy. Fraud determinations that were not supported upon review were overturned, and any collections assigned to them were reversed and refunded. The reduction in receivables and the refunds issued due to this project had a negative impact on the fund's revenues. To identify this one-time activity and to provide a more accurate depiction of the actual activity during the year, the fund separately reported the expenditure of the project's refunds in the income statement.