



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

REPORT ON INTERNAL CONTROL,
COMPLIANCE, AND OTHER MATTERS

MICHIGAN STRATEGIC FUND

(A Discretely Presented Component Unit of the State of Michigan)

Fiscal Year Ended September 30, 2013



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

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

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Michigan
Office of the Auditor General
REPORT SUMMARY

*Report on Internal Control, Compliance, and
Other Matters*

Michigan Strategic Fund

(A Discretely Presented Component Unit of the State of Michigan)

Fiscal Year Ended September 30, 2013

Report Number:
271-0401-14M

Released:
April 2014

Generally accepted government auditing standards require an auditor to report on internal control over financial reporting; compliance with provisions of laws, regulations, contracts, or grant agreements that have a material effect on the financial statements; and other matters coming to the attention of the auditor during the completion of a financial audit. This report is being issued in conjunction with our financial audit of the Michigan Strategic Fund (MSF).

Financial Statements:

Auditor's Report Issued

We have audited MSF's basic financial statements as of and for the fiscal year ended September 30, 2013 and have issued a separate report thereon dated February 3, 2014. We issued unmodified opinions on MSF's basic financial statements.

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Internal Control Over Financial Reporting

In planning and performing our audit of the basic financial statements, we considered MSF's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of MSF's internal control. Accordingly, we do not express an opinion on the effectiveness of MSF's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, we did not identify any deficiencies in internal control that we consider to be material weaknesses; however, material weaknesses may exist that have not been identified. We did identify significant deficiencies (Findings 1 through 3). A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Investment Impairment Losses

MSF's internal control over financial reporting did not ensure that it properly recorded and reported investment

impairment losses in accordance with generally accepted accounting principles (Finding 1).

Loan Interest Revenue

MSF's internal control over financial reporting did not ensure that it properly recorded and reported loan interest revenue related to capitalized interest in accordance with generally accepted accounting principles (Finding 2).

Salesforce Access Controls

MSF had not established effective access controls over its Salesforce customer relationship management system (Finding 3).

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**Noncompliance and Other Matters
Material to the Financial Statements**

We did not identify any instances of noncompliance or other matters applicable to the basic financial statements that are required to be reported under *Government Auditing Standards*.

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Agency Response:

This report contains 3 findings and 3 corresponding recommendations. MSF's preliminary response indicates that it agrees with all of the recommendations.

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Background:

Act 270, P.A. 1984, created MSF. Executive Order No. 1999-1, effective April 5, 1999, transferred MSF to the Department of Management and Budget as an autonomous agency, governed by a Board of Directors. Executive Order No. 2003-18, effective December 7, 2003, transferred MSF as an autonomous agency to the Department of Energy, Labor & Economic Growth (DELEG). Effective November 21, 2005, Act 225, P.A. 2005, transferred MSF as an autonomous agency from DELEG to the Department of Treasury. MSF is a discretely presented component unit of the financial reporting entity of the State of Michigan.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: <http://audgen.michigan.gov>



Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

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

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



STATE OF MICHIGAN
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

April 8, 2014

Mr. Michael A. Finney
President and Chief Executive Officer, Michigan Strategic Fund
Chair, Michigan Strategic Fund Board of Directors
300 North Washington Square
Lansing, Michigan

Dear Mr. Finney:

We have audited the financial statements of the governmental activities and each major fund of the Michigan Strategic Fund (MSF), a discretely presented component unit of the State of Michigan, as of and for the fiscal year ended September 30, 2013 and the related notes to the financial statements, which collectively comprise MSF's basic financial statements, and have issued a separate report thereon dated February 3, 2014. In planning and performing our audit of the financial statements, we considered MSF's internal control over financial reporting and compliance and other matters. This report on internal control, compliance, and other matters is being issued in conjunction with our financial audit of MSF for the fiscal year ended September 30, 2013.

This report contains our report summary; our independent auditor's report on internal control over financial reporting and on compliance and other matters; our findings, our recommendations, and the agency preliminary responses; and a glossary of abbreviations and terms.

The agency preliminary responses were taken from the agency's response at the end of our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a plan to comply with the audit recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

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

Sincerely,

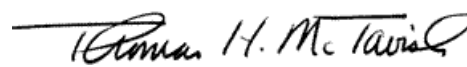

Thomas H. McTavish, C.P.A.
Auditor General

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

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

Mr. Michael A. Finney
President and Chief Executive Officer, Michigan Strategic Fund
Chair, Michigan Strategic Fund Board of Directors
300 North Washington Square
Lansing, Michigan

Dear Mr. Finney:

We have audited, in accordance with the 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, the financial statements of the governmental activities and each major fund of the Michigan Strategic Fund, a discretely presented component unit of the State of Michigan, as of and for the fiscal year ended September 30, 2013 and the related notes to the financial statements, which collectively comprise the Michigan Strategic Fund's basic financial statements, and have issued our report thereon dated February 3, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the basic financial statements, we considered the Michigan Strategic Fund's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Michigan Strategic Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Michigan Strategic Fund's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's basic financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control, as described in Findings 1 through 3, that we consider to be significant deficiencies.

Compliance and Other Matters

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

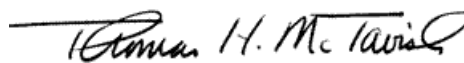
Michigan Strategic Fund's Response to Findings

The Michigan Strategic Fund's preliminary responses to the findings identified in our audit are included in the body of our report. The Michigan Strategic Fund's preliminary responses were not subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Sincerely,



Thomas H. McTavish, C.P.A.
Auditor General
February 3, 2014

FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

FINDING

1. Investment Impairment Losses

The Michigan Strategic Fund's (MSF's) internal control* over financial reporting did not ensure that it properly recorded and reported investment impairment losses in accordance with generally accepted accounting principles* (GAAP). As a result, MSF overstated its investments and net increase (decrease) in fair value of investments by \$751,266 in its fiscal year 2012-13 governmental fund and government-wide financial statements.

Section I50.121 of the *Codification of Governmental Accounting and Financial Reporting Standards* (Codification), published by the Governmental Accounting Standards Board* (GASB), provides that, when using the cost method to account for common stock investments, a decrease in value of the investment should be recognized when factors indicate that a nontemporary impairment loss has occurred, such as a series of operating losses of the investee.

As of September 30, 2013, MSF reported the value of its venture capital investments as \$31.5 million. During our testing of MSF's reported value of its venture capital investments, we noted that MSF did not recognize an impairment loss for one investment totaling \$751,266, although MSF had determined that a loan receivable it held from the same company was uncollectible.

MSF informed us that it did not adjust investment values for nontemporary impairment losses unless a significant event occurred, such as a bankruptcy filing or the closing of the investee's business. MSF did not consider other factors that could cause an investment impairment loss, such as sustained operating losses of an investee or nonpayment of the investee's outstanding loans.

RECOMMENDATION

We recommend that MSF implement internal control over financial reporting to ensure that it properly records and reports investment impairment losses in accordance with GAAP.

* See glossary at end of report for definition.

AGENCY PRELIMINARY RESPONSE

MSF agrees with the recommendation and indicated that MSF's long-standing policy has been to adjust investment values for impairment losses only when a significant event occurred, such as bankruptcy filing or the closing of the investee's business. MSF indicated that it will implement a process to also include an annual review of investments that will consider any known factors that could cause an investment impairment loss.

FINDING

2. Loan Interest Revenue

MSF's internal control over financial reporting did not ensure that it properly recorded and reported loan interest revenue in accordance with GAAP. As a result, MSF could not ensure the prevention or detection of misstatements in interest and investment earnings revenue reported in its financial statements.

GASB Codification Section 1600.106 provides that revenues and other governmental fund financial resources should be recognized in governmental fund financial statements in the accounting period in which they become both measurable and available to finance expenditures of the fiscal period. "Available" means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period. Also, GASB Codification Section 1600.104 provides that revenue from exchange transactions generally should be recognized in government-wide financial statements when an exchange takes place, unless the collection of amounts is not reasonably assured.

Select MSF loan agreements allow the borrower to delay making loan payments for several years, after which all accrued unpaid interest is added to the principal balance of the loan and the repayment period commences. MSF's methodology was to record an increase in both the loans receivable balance and the interest and investment earnings revenue based on the amount of the accrued interest on the capitalization date specified in the loan agreement.

Our testing of loan interest revenue recorded for loans accounted for in MSF's Jobs for Michigan Investment Fund disclosed:

- a. MSF did not properly record loan interest revenue related to capitalized interest that was not considered available. As a result, MSF overstated its interest and investment earnings revenue and beginning fund balance by \$1.3 million and \$4.1 million, respectively, and MSF understated its deferred revenue by \$5.3 million in its fiscal year 2012-13 governmental fund financial statements. When brought to MSF's attention, MSF subsequently corrected its financial statements and properly disclosed the accounting restatement in its financial statement notes.
- b. MSF improperly recorded loan interest receivable and corresponding revenue for loans that MSF deemed uncollectible. Because MSF deemed the loan uncollectible, it should not have recorded interest receivable and corresponding revenue for the loan. As a result, MSF overstated both its interest revenue and receivable write-off expenditures by \$797,356 in its fiscal year 2012-13 governmental fund financial statements and in its government-wide financial statements.

RECOMMENDATION

We recommend that MSF implement internal control over financial reporting to ensure that it properly records and reports loan interest revenue in accordance with GAAP.

AGENCY PRELIMINARY RESPONSE

MSF agrees with the recommendation. MSF believes that it is important to note that this was a revenue classification error and did not impact MSF's fund balance in prior years. As noted in the finding, MSF changed the fiscal year 2012-13 financial statements to reflect this finding on the collectible loans. MSF also stated that it has changed its revenue recording method for future years to verify and report classifications in accordance with GAAP.

FINDING

3. Salesforce Access Controls

MSF had not established effective access controls* over its Salesforce customer relationship management system (Salesforce). As a result, MSF could not ensure that payment requests initiated through Salesforce were properly authorized and for the correct amounts prior to recording the payments in its financial accounting systems.

Department of Technology, Management, and Budget (DTMB) Administrative Guide policy 1335 and related technical standards provide that management of State agency information systems implement sufficient system access controls to ensure that users perform only authorized activities relevant to their respective job requirements and to ensure adequate segregation of duties* in performing activities. DTMB Administrative Guide policy 1335 and related technical standards also provide that management should perform a regular review of all accounts and related privileges.

MSF uses Salesforce to track and document payment requests for many of its grants, loans, and contracts. MSF reported that total payments authorized through Salesforce for both MSF and Michigan Economic Development Corporation programs totaled \$71.3 million in fiscal year 2012-13.

Our review of MSF's access controls over Salesforce disclosed:

- a. MSF did not limit the number of system administrators* and did not assign appropriate access rights to system administrators to ensure proper segregation of duties. We noted 18 system administrators who had the ability to log in as other users and perform activities without the use of a user password.
- b. MSF did not sufficiently monitor user activity, including system administrators, within Salesforce to ensure that users performed only authorized activities relevant to their respective jobs and positions. For example, users with the ability to approve grant payments also had the ability to change payment

* See glossary at end of report for definition.

amounts prior to approving payments in Salesforce. MSF informed us that, although an audit trail exists in Salesforce, it did not regularly monitor this audit trail.

- c. MSF had not established a formal process to periodically review user access rights to ensure that only authorized users had access to Salesforce and that the users' access rights were commensurate with their job duties.

RECOMMENDATION

We recommend that MSF establish effective access controls over Salesforce.

AGENCY PRELIMINARY RESPONSE

MSF agrees with the recommendation and indicated that it has implemented or will implement corrective action. MSF also believes that it is important to note there is no evidence or even a suggestion of abuse of Salesforce system administrator privileges. MSF informed us that it has implemented the following corrective actions:

- In response to part a., MSF has reduced the number of system administrators from 18 to 13 and will review the necessity of these privileges on an ongoing basis.
- In response to part b., MSF has determined that Salesforce has the capability to disable the global capability for system administrators to log on as other users. MSF has requested Salesforce to disable this feature.

The following corrective actions will be implemented within the next 60 days:

- In response to part b., MSF will set up procedures to monitor existing payment-related audit trails on a regular basis.
- In response to part c., MSF will set up a process to periodically check user access rights and privileges to ensure that the users' access rights are in sync with their job duties.

GLOSSARY

Glossary of Abbreviations and Terms

access controls	Controls that protect data from unauthorized modification, loss, or disclosure by restricting access and detecting inappropriate access attempts.
Codification	<i>Codification of Governmental Accounting and Financial Reporting Standards.</i>
deficiency in internal control over financial reporting	The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.
DELEG	Department of Energy, Labor & Economic Growth.
DTMB	Department of Technology, Management, and Budget.
financial audit	An audit that is designed to provide reasonable assurance about whether the basic financial statements of an audited entity are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.
generally accepted accounting principles (GAAP)	A technical accounting term that encompasses the conventions, rules, guidelines, and procedures necessary to define accepted accounting practice at a particular time; also cited as "accounting principles generally accepted in the United States of America."
Governmental Accounting Standards Board (GASB)	An arm of the Financial Accounting Foundation established to promulgate standards of financial accounting and reporting with respect to activities and transactions of state and local governmental entities.

internal control	A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
material misstatement	A misstatement in the basic financial statements that causes the statements to not present fairly the financial position or the changes in financial position, and, where applicable, cash flows thereof, in accordance with the applicable financial reporting framework.
material weakness in internal control over financial reporting	A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the basic financial statements will not be prevented, or detected and corrected, on a timely basis.
MSF	Michigan Strategic Fund.
Salesforce	Salesforce customer relationship management system.
segregation of duties	Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of his or her duties. Proper segregation of duties requires separating the duties of reporting, review and approval of reconciliations, and approval and control of documents.
significant deficiency in internal control over financial reporting	A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

system administrator The person responsible for administering use of a multiuser computer system, communications system, or both.

unmodified opinion The opinion expressed by the auditor when the auditor, having obtained sufficient appropriate audit evidence, concludes that the basic financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

