



# MICHIGAN

OFFICE OF THE AUDITOR GENERAL



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

Audit report information can be accessed at:

*<http://audgen.michigan.gov>*



Michigan  
*Office of the Auditor General*  
**REPORT SUMMARY**

*Management Letter*

Report Number:  
 071-0156-10M

*State of Michigan 401K Plan*

*October 1, 2008 through September 30, 2009*

Released:  
 February 2010

*The management letter is used to report significant deficiencies in internal control over financial reporting and other matters that come to the auditor's attention during the completion of the financial audit conducted in accordance with generally accepted government auditing standards. This management letter is being issued in conjunction with our financial audit of the State of Michigan 401K Plan, a pension (and other employee benefit) trust fund of the State of Michigan.*

**Financial Statements:**

**Auditor's Report Issued**

We have audited the financial statements of the State of Michigan 401K Plan as of and for the fiscal year ended September 30, 2009 and have issued a separate report thereon dated December 22, 2009. We issued an unqualified opinion on the State of Michigan 401K Plan financial statements.

~ ~ ~ ~ ~

**Internal Control Over Financial Reporting**

We identified a significant deficiency in internal control over financial reporting (Finding 1). We do not consider this significant deficiency to be a material weakness.

The Office of Retirement Services, Department of Management and Budget (DMB), and DMB Financial Services need to improve their financial monitoring of the third party administrator for the State of Michigan 401K Plan to ensure the

completeness and accuracy of the Plan's financial records (Finding 1).

~ ~ ~ ~ ~

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

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

~ ~ ~ ~ ~

**Agency Response:**

Our management letter includes 1 finding and 1 corresponding recommendation. The Office of Retirement Services and DMB Financial Services' preliminary response indicated that they agree with the finding.

~ ~ ~ ~ ~

**Background:**

The State of Michigan 401K Plan is a pension (and other employee benefit) trust fund of the State of Michigan. The Plan

was established by the Civil Service Commission in 1985 as a 401k plan and amended in March 1997 to implement a defined contribution component as a means for all employees to build funds for retirement. All employees of the State are eligible to participate in the Plan on the first day of employment and may voluntarily contribute a portion of their compensation up to the established Internal Revenue Service limits.

The Plan provides for the State of Michigan to make a mandatory contribution of 4.0 percent and matching contributions up to a maximum of 3.0 percent of each participant's compensation for employees not covered by the State's defined benefit plans. Participants are 100 percent vested in their salary deferrals at all times and vest in the employer contributions based on years of service.

There is also a State of Michigan 457 Plan, which is a pension (and other employee benefit) trust fund of the State of Michigan. State employees are eligible to participate in either or both of these plans. We issued a separate audit report on the State of Michigan 457 Plan financial statements.

~ ~ ~ ~ ~ ~ ~ ~ ~ ~

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  
OFFICE OF THE AUDITOR GENERAL  
201 N. WASHINGTON SQUARE  
LANSING, MICHIGAN 48913  
(517) 334-8050  
FAX (517) 334-8079

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

February 25, 2010

Ms. Phyllis Mellon, Acting Director  
Department of Management and Budget  
Lewis Cass Building - Second Floor  
Lansing, Michigan  
and  
Mr. Phillip Stoddard, Director  
Office of Retirement Services  
Department of Management and Budget  
General Office Building - Third Floor  
Lansing, Michigan

Dear Ms. Mellon and Mr. Stoddard:

We have audited the financial statements of the State of Michigan 401K Plan as of and for the fiscal year ended September 30, 2009 and have issued a separate report thereon dated December 22, 2009. In planning and performing our audit of the financial statements of the Plan, we considered the Plan's internal control over financial reporting and compliance and other matters. This is our management letter on the internal control over financial reporting and on compliance and other matters of the State of Michigan 401K Plan for the period October 1, 2008 through September 30, 2009.

This management letter contains our report summary; our independent auditor's report on internal control over financial reporting and on compliance and other matters; our finding, recommendation, and the agency preliminary response; and a glossary of acronyms and terms.

The agency preliminary response was taken from the agency's response subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

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

AUDITOR GENERAL



# TABLE OF CONTENTS

## STATE OF MICHIGAN 401K PLAN

|  | <u>Page</u> |
|--|-------------|
| INTRODUCTION   |             |
| Report Summary   | 1           |
| Report Letter  | 3           |
| INDEPENDENT AUDITOR'S REPORT ON<br>INTERNAL CONTROL AND COMPLIANCE   |             |
| Independent Auditor's Report on Internal Control Over Financial Reporting<br>and on Compliance and Other Matters | 8           |
| FINDING, RECOMMENDATION, AND<br>AGENCY PRELIMINARY RESPONSE  |             |
| 1. Controls Over Financial Monitoring of the Third Party Administrator (TPA)                                     | 11          |
| GLOSSARY   |             |
| Glossary of Acronyms and Terms   | 14          |



INDEPENDENT AUDITOR'S REPORT ON  
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN  
OFFICE OF THE AUDITOR GENERAL  
201 N. WASHINGTON SQUARE  
LANSING, MICHIGAN 48913  
(517) 334-8050  
FAX (517) 334-8079

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

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

Ms. Phyllis Mellon, Acting Director  
Department of Management and Budget  
Lewis Cass Building - Second Floor  
Lansing, Michigan  
and  
Mr. Phillip Stoddard, Director  
Office of Retirement Services  
Department of Management and Budget  
General Office Building - Third Floor  
Lansing, Michigan

Dear Ms. Mellon and Mr. Stoddard:

We have audited the statement of plan net assets of the State of Michigan 401K Plan as of September 30, 2009 and related statement of changes in plan net assets for the fiscal year then ended and have issued our report thereon dated December 22, 2009. 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.

### Internal Control Over Financial Reporting

In planning and performing our audit, we considered the State of Michigan 401K Plan's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of Michigan 401K Plan's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State of Michigan 401K Plan's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed in the next paragraph, we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiency described in Finding 1 to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that the significant deficiency described in the third paragraph of this section is not a material weakness.

#### Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Michigan 401K Plan's financial statements are free of 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*.

The agency preliminary response to the finding identified in our audit is included in the body of our management letter. We did not audit the agency preliminary response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Governor, the Legislature, the State of Michigan 401K Plan management, and others within the Department of Management and Budget 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

December 22, 2009

**FINDING, RECOMMENDATION, AND  
AGENCY PRELIMINARY RESPONSE**

## **FINDING**

### **1. Controls Over Financial Monitoring of the Third Party Administrator (TPA)**

The Office of Retirement Services (ORS), Department of Management and Budget (DMB), and DMB Financial Services need to improve their financial monitoring of the TPA for the State of Michigan 401K Plan to ensure the completeness and accuracy of the Plan's financial records. As a result, ORS and DMB Financial Services could not ensure that all information was properly considered for inclusion in or exclusion from the financial statements, that all adjustments made by the TPA were proper, and that investment activity was properly recorded throughout the fiscal year.

ORS contracts with a TPA to provide recordkeeping, administration, custodial, and education services for the State of Michigan 401K Plan. This includes maintaining separate and distinct accounts for each participant for whom contributions, benefit payments, loans, and investment earnings are recorded. ORS also has a business partnership agreement with DMB Financial Services to provide the State of Michigan 401K Plan with the accounting services to record the financial transactions and prepare the financial statements. On a monthly basis, the TPA provides DMB Financial Services with a reconciliation of the investment account activity, for each plan, for that month. The TPA also reconciles the participants' accounts to the investment accounts on a monthly basis.

Our review of ORS and DMB Financial Services' financial monitoring disclosed:

- a. ORS and DMB Financial Services were not aware that defaulted loans were included in the investment accounts. The TPA's monthly reconciliations included defaulted loans totaling \$17.9 million in its investment accounts to enable the tracking of the historical information and to comply with plan provisions related to participant eligibility for loans. As a result, the participant loan receivable for the State of Michigan 401K Plan was overstated by \$17.9 million as of September 30, 2009. Subsequent to our review, ORS and DMB Financial Services corrected the financial statements to remove the \$17.9 million in defaulted loans from the State of Michigan 401K Plan's statement of plan net assets.
- b. DMB Financial Services did not follow up with the TPA to obtain an explanation and understanding of unreconciled differences on the TPA's monthly reports. ORS and DMB Financial Services analyzed the monthly reconciliations of the

investment account activity provided by the TPA and requested further information and explanation on unreconciled differences from the TPA. However, the TPA did not respond to DMB Financial Services. As a result, an adjustment in contributions recorded by the TPA between the 401k and defined contribution components within the State of Michigan 401K Plan totaling \$1.8 million in fiscal year 2008-09 was not detected and investigated for propriety by ORS and DMB Financial Services.

### **RECOMMENDATION**

We recommend that ORS and DMB Financial Services improve their financial monitoring of the TPA for the State of Michigan 401K Plan to ensure the completeness and accuracy of the Plan's financial records.

### **AGENCY PRELIMINARY RESPONSE**

ORS and DMB Financial Services agree with the finding. DMB Financial Services corrected the fiscal year 2008-09 financial statements for the current and all prior periods for the defaulted loans. ORS and DMB Financial Services indicated that they have informed the TPA that defaulted loan information will be required to be submitted by the TPA to DMB Financial Services each year.

ORS and DMB Financial Services informed us that \$1.8 million in unreconciled differences represents only approximately 0.8% of total annual contributions to the State of Michigan 401K Plan and that those unreconciled differences have historically been identified and reconciled as year-end entries. ORS and DMB Financial Services also informed us that they will work with the TPA to require timely response to all inquiries on a quarterly basis and will work with the TPA to develop and implement a process to escalate issues should timely explanations of any reconciling items not be provided. They informed us that the process is expected to be in place by June 30, 2010.

# GLOSSARY

## Glossary of Acronyms and Terms

|   |  |
|---|--|
| control 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 misstatements on a timely basis.   |
| DMB   | Department of Management and Budget.   |
| financial audit   | An audit that is designed to provide reasonable assurance about whether the financial statements of an audited entity are presented fairly in all material respects in conformity with the disclosed basis of accounting.  |
| 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 financial statements that causes the statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.  |
| material weakness in internal control over financial reporting  | A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.  |
| ORS   | Office of Retirement Services.   |

significant deficiency  
in internal control over  
financial reporting

A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

TPA

third party administrator.

unqualified opinion

An auditor's opinion in which the auditor states that the financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting.





