MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

FINANCIAL AUDIT
OF THE

MICHIGAN EDUCATION TRUST PLANS B AND C

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

October 1, 2010 through September 30, 2012

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

271-0284-13

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

Financial Audit

Michigan Education Trust Plans B and C

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

October 1, 2010 through September 30, 2012

Report Number:
271-0284-13

Released:
December 2012

A financial audit determines if the financial statements are fairly presented; considers internal control over financial reporting; and determines compliance with requirements material to the financial statements. This financial audit of the Michigan Education Trust (MET) Plans B and C was conducted as part of the constitutional responsibility of the Office of the Auditor General.

Financial Statements:

Auditor's Report Issued

We issued an unqualified opinion on the MET Plans B and C financial statements.

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Internal Control Over Financial Reporting

We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, we did identify a significant deficiency (Finding 1).

MET had not implemented proper segregation of duties over the administration of MET benefits (Finding 1).

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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 financial statements that are required to be reported under *Government Auditing Standards*.

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Agency Response:

Our audit report contains 1 finding and 1 corresponding recommendation. MET's preliminary response indicates that it agrees with the recommendation and will comply.

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Background:

MET was created under Act 316, P.A. 1986, to operate a prepaid college tuition program that will provide a Michigan child's undergraduate tuition at any Michigan public university or community college. MET is governed by a 9-member Board of Directors that consists of the State Treasurer and 8 public members who are appointed by the Governor with the advice and consent of the Senate.

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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
OFFICE OF THE AUDITOR GENERAL
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

December 21, 2012

Mr. Andy Dillon, State Treasurer and Chair
Michigan Education Trust Board of Directors
and
Ms. Robin R. Lott, Executive Director
Michigan Education Trust
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Dillon and Ms. Lott:

This is our report on the financial audit of the Michigan Education Trust (MET) Plans B and C, a discretely presented component unit of the State of Michigan, for the period October 1, 2010 through September 30, 2012.

This report contains our report summary, our independent auditor's report on the financial statements, the MET management's discussion and analysis, and the MET Plans B and C basic financial statements. This report also contains our independent auditor's report on internal control over financial reporting and on compliance and other matters; our finding, recommendation, and 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 plan to comply with the audit recommendation 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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GLOSSARY

INDEPENDENT AUDITOR'S REPORT

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

Independent Auditor's Report on
the Financial Statements

Mr. Andy Dillon, State Treasurer and Chair
Michigan Education Trust Board of Directors
and
Ms. Robin R. Lott, Executive Director
Michigan Education Trust
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Dillon and Ms. Lott:

We have audited the statement of net assets; the statement of revenues, expenses, and changes in net assets; and the statement of cash flows of the Michigan Education Trust Plans B and C, a discretely presented component unit of the State of Michigan, as of and for the fiscal years ended September 30, 2012 and September 30, 2011. These financial statements are the responsibility of the Michigan Education Trust's management. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the financial statements present only the Michigan Education Trust Plans B and C and do not purport to, and do not, present fairly the financial position of the State of Michigan or its component units, or the Michigan Education Trust Plan D, as of September 30, 2012 and September 30, 2011 and the changes in its financial position or, where applicable, its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Michigan Education Trust Plans B and C as of September 30, 2012 and September 30, 2011 and the changes in its financial position and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 17, 2012 on our consideration of the Michigan Education Trust'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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic 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 basic financial statements, and other knowledge we obtained during our audit of the basic 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.

Sincerely,

Thomas H. McTavish

Thomas H. McTavish, C.P.A.
Auditor General
December 17, 2012

MANAGEMENT'S DISCUSSION AND ANALYSIS

This is a discussion and analysis of the financial performance of the Michigan Education Trust (MET) Plans B and C for the fiscal years ended September 30, 2012 and September 30, 2011. MET is an Internal Revenue Code Section 529 qualified tuition program and is a discretely presented component unit of the State of Michigan, administratively located within the Department of Treasury. MET's management is responsible for the financial statements, notes to the financial statements, and this discussion.

Using the Financial Report

This financial report includes the report of independent auditors, management's discussion and analysis, the basic financial statements, and notes to the financial statements.

The reporting standards in Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, require a statement of net assets; a statement of revenues, expenses, and changes in net assets; and a statement of cash flows. These financial statements are interrelated and represent the financial status of MET Plans B and C.

The statement of net assets includes the assets, liabilities, and net assets at the end of the fiscal year. The statement of revenues, expenses, and changes in net assets presents the revenues earned and expenses incurred during the fiscal year. The statement of cash flows presents information related to cash inflows and outflows summarized by operating and investing activities.

Financial Analysis of MET Plans B and C

The MET Board of Directors approves an annual budget and the investment portfolio allocation. The Bureau of Investments, Department of Treasury, under the direction of the MET Board of Directors, is responsible for short-term and long-term investment of MET funds. The MET portfolio for Plans B and C is invested 100% in fixed income investments.

MET funds are invested to coincide with the students' expected years of high school graduation. Once students activate their contracts, colleges and universities submit invoices to MET every semester for tuition and mandatory fees. In 2006, the MET

Board approved an amendment allowing students 15 years from the expected year of high school graduation to completely use MET contract benefits. Prior to that change, students had 9 years to use MET contract benefits.

Annually, the actuary determines the actuarial soundness of each MET plan. Key factors used in the soundness analysis are tuition increases (short-term and long-term), investment performance, and college selection by students and purchasers.

Comparison of Current Year and Prior Year Results

Condensed Financial Information
From the Statement of Net Assets
As of September 30
(In Thousands)

	2012	2011	2010
Current assets	$ 65,382	$ 85,667	$103,626
Noncurrent assets	109,137	114,729	138,751
Total assets	$174,519	$200,396	$242,377
Current liabilities	$ 61,007	$ 63,011	$ 77,008
Noncurrent liabilities	96,145	126,262	136,894
Total liabilities	$157,153	$189,274	$213,902
Net assets - Restricted	$ 17,366	$ 11,122	$ 28,475
Total net assets	$ 17,366	$ 11,122	$ 28,475

Total net assets increased by $6.2 million in fiscal year 2011-12 and decreased by $17.4 million in fiscal year 2010-11. The net assets increased in fiscal year 2011-12 because of favorable investment performance at year-end. The net assets decreased in fiscal year 2010-11 because of the decrease in fair value of investments at year-end and a change in the discount rate and tuition increase assumption.

Current assets decreased by $20.3 million in fiscal year 2011-12 and decreased by $18.0 million in fiscal year 2010-11 primarily because of the decrease in cash and cash equivalents that were used to pay tuition benefit payments.

Noncurrent assets decreased by $5.6 million in fiscal year 2011-12 and decreased by $24.0 million in fiscal year 2010-11. The decreases were a result of the MET Plans B and C being closed to new contracts and the liquidation of investments to meet the increased tuition benefit payments.

Total liabilities decreased by $32.1 million in fiscal year 2011-12 and decreased by $24.6 million in fiscal year 2010-11. The tuition benefits payable decrease reflects the increase in tuition contract payments made to colleges.

Condensed Financial Information
From the Statement of Revenues, Expenses, and Changes in Net Assets
Fiscal Years Ended September 30
(In Thousands)

	2012	2011	2010
Operating revenues			
Interest and dividends income	$ 3,273	$ 3,340	$ 4,482
Net increase (decrease) in the fair value of investments	520	(942)	3,777
Other miscellaneous income	25	28	29
Total operating revenues	$ 3,818	$ 2,427	$ 8,288
Operating expenses			
Salaries and other administrative expenses	$ 698	$ 846	$ 913
Net increase (decrease) in the present value of tuition benefits payable	(3,124)	18,933	1,403
Total operating expenses	$ (2,426)	$ 19,779	$ 2,315
Operating income (loss)	$ 6,244	$ (17,352)	$ 5,973
Increase (Decrease) in net assets	$ 6,244	$ (17,352)	$ 5,973
Net assets - Beginning of fiscal year	11,122	28,475	22,502
Net assets - End of fiscal year	$ 17,366	$ 11,122	$ 28,475

Interest and dividends income decreased by $0.7 million in fiscal year 2011-12 and decreased by $1.1 million in fiscal year 2010-11. The decreases were attributed to decreases in investments held during the fiscal year.

The **net increase (decrease) in the fair value of investments** increased by $1.5 million in fiscal year 2011-12 and decreased by $4.7 million in fiscal year 2010-11. The increase in fiscal year 2011-12 was because of favorable investment performance. The decrease in fiscal year 2010-11 was because of losses on sold investments. The actual investment rate of return was 2.2% in fiscal year 2011-12 and 1.2% in fiscal year 2010-11.

The **net increase (decrease) in the present value of tuition benefits payable** decreased by $22.1 million in fiscal year 2011-12 and increased by $17.5 million in fiscal year 2010-11. The decrease and increase in both fiscal years resulted from the change in the present value of the future tuition benefit obligation compared to actuarial tuition assumptions.

Condensed Financial Information
From the Statement of Cash Flows
Fiscal Years Ended September 30
(In Thousands)

	2012	2011	2010
Net cash provided (used) by:			
Operating activities	$ (31,665)	$ (41,076)	$ (59,790)
Investing activities	6,111	25,224	5,391
Net cash provided (used) - All activities	(25,554)	$ (15,852)	$ (54,399)
Cash and cash equivalents - Beginning of fiscal year	77,186	93,038	147,437
Cash and cash equivalents - End of fiscal year	$ 51,632	$ 77,186	$ 93,038

The **net cash used by operating activities** decreased by $9.4 million in fiscal year 2011-12 and decreased by $18.7 million in fiscal year 2010-11. The decreases in cash used by operating activities in both fiscal years were primarily the result of decreases in tuition contract payments to colleges and refund designees.

The **net cash provided by investing activities** decreased by $19.1 million in fiscal year 2011-12 and increased by $19.8 million in fiscal year 2010-11. The decrease in cash provided by investing activities in fiscal year 2011-12 resulted from the decreased amount of cash available for investing purposes. The increase in cash provided in fiscal year 2010-11 resulted when some of the investments matured and the proceeds from the long-term portfolio were used to make tuition payments.

Overall, the **cash and cash equivalents at the end of the fiscal year** decreased by $25.6 million in fiscal year 2011-12 and decreased by $15.9 million in fiscal year 2010-11.

Factors Impacting Future Periods

It is expected that Michigan public universities will adopt higher tuition increases next year if State appropriated funds decrease.

MET Plans B and C reached the peak matriculation period during fiscal year 2005-06. During fiscal year 2012-13, 505 students will be eligible to begin using MET contracts to attend college along with 7,520 students currently in the process of using MET contracts. After fiscal year 2012-13, the number of students expected to enroll in college under MET Plans B and C will continue to decrease significantly because MET has fulfilled its contractual obligations for the majority of these contract holders and has not offered additional enrollments in these plans since 1990.

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BASIC FINANCIAL STATEMENTS

MICHIGAN EDUCATION TRUST PLANS B AND C
Statement of Net Assets
As of September 30

	2012	2011
ASSETS		
Current assets:		
Cash and cash equivalents (Notes 2 and 3)	$ 51,632,310	$ 77,186,293
Amounts due from MET Program (Plan D)	3,215,643	3,029,277
Amounts due from primary government	9,645,286	4,825,660
Interest and dividends receivable	888,739	625,920
Total current assets	$ 65,381,979	$ 85,667,150
Noncurrent assets:		
Investments (Note 3)	109,137,337	114,728,669
Total assets	$ 174,519,316	$ 200,395,819
LIABILITIES		
Current liabilities:		
Tuition benefits payable (Note 4)	$ 61,000,000	$ 63,000,000
Compensated absences	7,418	11,495
Total current liabilities	$ 61,007,418	$ 63,011,495
Noncurrent liabilities:		
Tuition benefits payable (Note 4)	95,994,889	126,088,688
Compensated absences	150,537	173,432
Total liabilities	$ 157,152,844	$ 189,273,615
NET ASSETS		
Net assets - Restricted	$ 17,366,472	$ 11,122,204
Total net assets	$ 17,366,472	$ 11,122,204

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

MICHIGAN EDUCATION TRUST PLANS B AND C
Statement of Revenues, Expenses, and Changes in Net Assets
Fiscal Years Ended September 30

	2012	2011
OPERATING REVENUES		
Interest and dividends income	$ 3,273,398	$ 3,340,343
Net increase (decrease) in the fair value of investments	519,832	(941,972)
Other miscellaneous income	25,012	28,409
Total operating revenues	$ 3,818,241	$ 2,426,779
OPERATING EXPENSES		
Salaries and other administrative expenses	$ 698,365	$ 846,198
Net increase (decrease) in the present value of tuition benefits payable	(3,124,392)	18,932,901
Total operating expenses	$ (2,426,026)	$ 19,779,099
Operating income (loss)	$ 6,244,268	$ (17,352,320)
Increase (Decrease) in net assets	$ 6,244,268	$ (17,352,320)
Net assets - Beginning of fiscal year	11,122,204	28,474,524
Net assets - End of fiscal year	$ 17,366,472	$ 11,122,204

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

MICHIGAN EDUCATION TRUST PLANS B AND C

Statement of Cash Flows

Fiscal Years Ended September 30

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Interest and dividends received	$ 3,010,579	$ 3,557,327
Benefits paid	(28,969,407)	(43,591,624)
Administrative and other expenses paid	(5,731,330)	(1,070,266)
Application and other fees collected	25,012	28,409
Net cash provided (used) by operating activities	$ (31,665,146)	$ (41,076,154)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investment securities	$ (55,191,905)	$ (15,290,401)
Proceeds from sale and maturities of investment securities	61,303,069	40,514,621
Net cash provided (used) by investing activities	$ 6,111,164	$ 25,224,220
Net cash provided (used) - All activities	$ (25,553,983)	$ (15,851,934)
Cash and cash equivalents - Beginning of fiscal year	77,186,293	93,038,227
Cash and cash equivalents - End of fiscal year	$ 51,632,310	$ 77,186,293
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating income (loss)	$ 6,244,268	$ (17,352,320)
Adjustments to reconcile operating income (loss) to net cash provided (used) by operating activities:		
Unrealized and realized (gains) losses	(519,832)	941,972
Changes in assets and liabilities:		
Amounts due from MET Program (Plan D)	(186,366)	(324,412)
Amounts due from others		16,447
Amounts due from primary government	(4,819,626)	53,117
Interest and dividends receivable	(262,819)	216,985
Compensated absences	(26,972)	31,680
Tuition benefits payable	(32,093,799)	(24,659,623)
Net cash provided (used) by operating activities	$ (31,665,146)	$ (41,076,154)

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

Note 1 Basis of Presentation and Reporting Entity

a. Basis of Presentation

The financial statements of the Michigan Education Trust (MET) Plans B and C have been prepared in accordance with accounting principles generally accepted in the United States of America as applicable to governmental units.

b. Reporting Entity

MET was created under Act 316, P.A. 1986 (Sections 390.1421 - 390.1444 of the *Michigan Compiled Laws*), to operate a prepaid college tuition program. MET is governed by a 9-member Board of Directors that consists of 1 ex-officio member (the State Treasurer, acting as chair) and 8 public members who are appointed by the Governor with the advice and consent of the Senate. MET is administratively located within the Department of Treasury. The State Treasurer, as MET's agent, may not commingle funds and must maintain a separate bank account for MET. MET is a proprietary component unit of the State of Michigan and is reported as such in the *State of Michigan Comprehensive Annual Financial Report*. The accompanying financial statements present only MET Plans B and C. Accordingly, they do not purport to, and do not, present fairly the financial position and changes in financial position and cash flows of the State of Michigan or its component units, or MET Plan D, in conformity with accounting principles generally accepted in the United States of America as applicable to governmental units.

Act 316, P.A. 1986, as amended, empowers MET, on behalf of itself and the State of Michigan, to enter into a contract with a purchaser which provides that, in return for a specified actuarially determined payment, MET will provide a Michigan child's undergraduate tuition at any Michigan public university or community college. The purchase amount is based on several factors, including tuition costs, anticipated investment earnings, anticipated tuition rate increases, and the type of contract purchased. MET offers a full benefits contract, a limited benefits contract, and a community college contract. MET's property, income, and operations have been statutorily exempted from all taxation by the State and its political subdivisions. The Act and the contracts specifically provide that the State is not liable if MET becomes actuarially unsound. In that event, the contracts provide for refunds to participants based on a proration of the remaining assets.

As of September 30, 2012, there have been 20 enrollment periods over 24 years for MET. The 1988, 1989, and 1990 enrollments are known as Plans B and C. The 1995, 1997, 1998, 1999, 2000, 2002, 2003, 2004, 2005, 2006, 2007 (two enrollment periods), 2008, 2009, 2010, 2011, and 2012 enrollments are known as Plan D. The Plan D enrollments are accounted for and reported separately from the Plans B and C enrollments. These financial statements report only Plans B and C enrollments. Separate financial statements and actuarial valuation of the Plan D enrollments are available from the MET office at P.O. Box 30198, Lansing, Michigan 48909.

Note 2 Summary of Significant Accounting Policies

a. Measurement Focus and Basis of Accounting

The financial statements contained in this report are prepared using the economic resources measurement focus and the accrual basis of accounting as provided by accounting principles generally accepted in the United States of America as applicable to governmental units. Under the accrual basis of accounting, revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of cash flows.

As allowed by Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, MET follows all GASB pronouncements and those Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures that were issued on or before November 30, 1989, except those that conflict with a GASB pronouncement. The FASB pronouncements issued after November 30, 1989 are not followed in the preparation of the accompanying financial statements.

b. Assets, Liabilities, and Net Assets

(1) Cash and Cash Equivalents: Cash and cash equivalents reported on the statement of net assets include deposits with financial institutions and short-term investments with original maturities of less than three months used for cash management rather than investing activities.

(2) Investments: MET's deposits and investments are held in a fiduciary capacity by the State Treasurer. Act 316, P.A. 1986, as amended, authorizes the MET Board of Directors to invest MET's assets in any instrument, obligation, security, or property that it considers to be appropriate. The Act also authorizes the pooling of MET's assets with assets of the State, such as the pension funds, for investment purposes. Investments are carried at fair value (see Note 3).

(3) Liabilities: The actuarial present value of the future tuition benefits obligation is recorded as a current and noncurrent liability of MET (see Note 4).

(4) Net Assets: MET's net assets represent the investment appreciation and the investment revenue in excess of the actuarial present value of the future tuition benefits obligation and expenses (see Note 4). Net assets are restricted because of the contractual obligations MET must adhere to on behalf of the purchasers and beneficiaries for which prepaid tuition was collected and invested. The enabling legislation for MET is Act 316, P.A. 1986, as amended. Section 17 of the Act indicates that the assets of the trust shall be preserved, invested, and expended solely pursuant to and for the purposes set forth in the Act and shall not be loaned or otherwise transferred or used by the State for any purpose other than the purposes of the Act.

Note 3 Deposits and Investments

a. General Information

In accordance with GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, policies and practices with respect to custodial credit risk, foreign currency risk, interest rate risk, credit risk, and concentration of credit risk are discussed in the following paragraphs.

b. Deposits

(1) Custodial Credit Risk

Custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, MET will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. MET does not have a policy for custodial credit risk for deposits.

At the end of fiscal year 2011-12, the carrying amount of MET's deposits for Plans B and C and the amount reflected in the accounts of the banks was $10,136,086. At the end of fiscal year 2010-11, the carrying amount of MET's deposits for Plans B and C and the amount reflected in the accounts of the banks was $25,552,078. The September 30, 2012 and September 30, 2011 balances were covered by federal depository insurance or collateral held with MET's agent in MET's name and, therefore, were not exposed to custodial credit risk.

(2) Foreign Currency Risk

Foreign currency risk for deposits is the risk that changes in exchange rates will adversely affect the fair value of a deposit. As of September 30, 2012 and September 30, 2011, MET had no foreign deposits.

c. Investments

(1) Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. MET does not have a policy to restrict interest rate risk for long-term investments.

The following table shows the fair value of investments for Plans B and C by investment type and in total (in millions) at September 30, 2012:

	Fair Value	Investment Maturities: Less Than 1 Year	1 to 5 Years	6 to 10 Years	More Than 10 Years
Investments:					
Commercial paper	$ 41.5	$ 41.5	$	$	$
U.S. agencies - sponsored	3.9		3.9		
Corporate bonds and notes	105.2	35.9	65.0	4.3	
Total investments	$ 150.6	$ 77.4	$ 68.9	$ 4.3	$ 0
Less investments reported as "cash equivalents" on statement of net assets	(41.5)				
Total investments	$ 109.1				
As Reported on the Statement of Net Assets					
Noncurrent restricted investments	$ 109.1				
Total investments	$ 109.1				

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The following table shows the fair value of investments for Plans B and C by investment type and in total (in millions) at September 30, 2011:

	Fair Value	Investment Maturities: Less Than 1 Year	1 to 5 Years	6 to 10 Years	More Than 10 Years
Investments:					
Commercial paper	$ 51.6	$ 51.6	$	$	$
U.S. agencies - sponsored	11.6	4.7	3.9	3.0	
Foreign government - sponsored	4.0	4.0			
Corporate bonds and notes	99.1	37.1	51.3	10.7	
Total investments	$ 166.3	$ 97.4	$ 55.2	$ 13.7	$ 0
Less investments reported as "cash equivalents" on statement of net assets	(51.6)				
Total investments	$ 114.7				

As Reported on the Statement of Net Assets

Noncurrent restricted investments	$ 114.7
Total investments	$ 114.7

(2) Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. MET limits investments in commercial paper, at the time of purchase, to the top two ratings issued by two national rating services: ratings of A-1 and A-2 from Standard & Poor's and ratings of P-1 and P-2 from Moody's Investors Service. MET's policy also limited investments in corporate bonds and mutual bond funds, at the time of purchase, to the top four ratings of the two rating services: ratings of AAA, AA, A, and BBB from Standard & Poor's and ratings of Aaa, Aa, A, and Baa from

Moody's Investors Service. As of September 30, 2012, the fair value (in millions) and credit quality ratings of investments were as follows:

Investment	Fair Value	Credit Quality Rating: Standard & Poor's	Credit Quality Rating: Moody's Investors Service
American Honda Finance Corp.	$ 2,549,008	A+	A1
AT&T Corp.	2,566,335	A-	WR
AT&T Inc.	3,152,280	A-	A2
Avon Products, Inc.	2,486,808	BBB-	Baa1
Bank of America Corp.	4,092,896	A-	Baa2
Berkshire Hathaway Inc.	3,152,313	AA+	Aa2
Cadbury Schweppes U.S. Finance LLC	4,160,420	BBB-	Baa2
Caterpillar Financial Services Corp.	4,434,601	A	A2
Duke Energy Corp.	3,219,945	BBB	Baa2
Duke Energy Ohio Inc.	2,094,846	A	A2
Eaton Corp.	3,079,455	A-	A3
Estee Lauder Companies Inc.	3,557,325	A	A2
Federal Home Loan Bank	3,910,624	AA+	Aaa
General Electric Capital Corp.	5,534,854	AA+	A1
General Electric Co.	10,432,670	AA+	A1
Georgia Power Co.	5,012,975	A	A3
Illinois Tool Works Inc.	3,207,906	A+	A1
JPMorgan Chase & Co	1,500,000	A	WR
JPMorgan Chase	2,665,625	A	A2
Oracle Corp.	1,816,367	A+	A1
PACCAR Financial Corp.	4,010,420	A+	A1
Procter & Gamble Company	3,209,412	AA-	Aa3
Public Service Colorado	2,000,000	A	WR
Public Service Electric & Gas Co.	4,027,468	A-	A1
Sherwin-Williams Co.	3,152,457	A	A3
Target Corp.	2,982,629	A+	A2
Tyco Electronics Group S.A.	2,131,750	BBB	Baa2
Verizon Virginia Inc.	2,545,990	A-	WR
Volkswagen International Finance N.V.	3,029,430	A-	A3
Wells Fargo & Company	9,420,530	A+	A2
Total fair value	$109,137,337		

As of September 30, 2011, the fair value (in millions) and credit quality ratings of investments were as follows:

Investment	Fair Value	Credit Quality Rating: Standard & Poor's	Credit Quality Rating: Moody's Investors Service
AT&T	$ 3,066,897	A-	A2
Avon Products, Inc.	2,626,022	BBB+	A2
Bank of America Corp.	3,966,876	A	Baa1
Caterpillar Financial Services Corp.	4,570,335	A	A2
Dell Inc.	2,543,470	A-	A2
Eaton Corp.	3,193,854	A-	A3
Estee Lauder Companies Inc.	3,428,751	A	A2
Federal Home Loan Bank	8,620,621	AA+	Aaa
Federal Farm Credit	3,038,640	AA+	Aaa
General Electric Capital Corp.	13,315,382	AA+	Aa2
Illinois Tool Works Inc.	3,284,439	A+	A1
JPMorgan Chase	2,510,310	A+	Aa3
KfW	4,003,360	AA	Aa3
Oracle Corp.	1,731,118	A	A1
Pfizer Inc.	3,051,228	AA	A1
Procter & Gamble Company	3,223,725	AA-	Aa3
Seariver Maritime Financial Holdings, Inc.	26,494,614	AAA	Aaa
Shell International Finance B.V.	4,311,516	AA	Aa1
Target Corp.	2,915,557	A+	A2
US Central Federal Credit Union	5,002,165	AA+	Aaa
Volkswagen International Finance N.V.	3,010,422	A-	A3
Wal-Mart Stores, Inc.	2,656,863	AA	Aa2
Wells Fargo & Company	4,162,504	AA-	A2
Total fair value	$114,728,669		

(3) Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, MET will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. MET's investments are registered in its name and, therefore, are not subject to custodial credit risk. MET does not have an investment policy for custodial credit risk.

(4) Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of MET's investments with a single issuer. MET does not have a policy to limit the concentration of credit risk. At September 30, 2012, MET had the following investments that represented 5% or more of total investments:

		Credit Quality Rating	
Investment	Fair Value	Standard & Poor's	Moody's Investors Service
General Electric Capital Corp.	$ 5,534,854	AA+	A1
General Electric Co.	$10,432,670	AA+	A1
Wells Fargo & Company	$ 9,420,530	A+	A2

At September 30, 2011, MET had the following investments that represented 5% or more of total investments:

		Credit Quality Rating	
Investment	Fair Value	Standard & Poor's	Moody's Investors Service
Federal Home Loan Bank	$ 8,620,621	AA+	Aaa
Seariver Maritime Financial Holdings, Inc.	$26,494,614	AAA	Aaa
General Electric Capital Corp.	$13,315,382	AA+	Aa2

(5) Foreign Currency Risk

Foreign currency risk for investments is the risk that changes in exchange rates will adversely affect the fair value of investments. As of September 30, 2012 and September 30, 2011, MET had no investments subject to foreign currency risk.

Note 4 Tuition Benefits Payable

The standardized measurement of the total benefits obligation of MET is the actuarial present value of the future tuition benefits obligation that will be paid in future years. The tuition benefits obligation is actuarially calculated by projecting the weighted average tuition cost, including mandatory fees, at the assumed annual rate of increase and then calculating the expected present value of the future distributions from the trust based on the investment income and discount rate assumptions. The following table shows the net value of total assets less compensated absences, the present value of total tuition benefits obligation, and the net assets of MET Plans B and C as of September 30:

	2012	2011
Net value of total assets less compensated absences	$174.4	$200.2
Present value of total tuition benefits obligation	157.0	189.1
Net value of assets in excess of tuition benefits obligation	$ 17.4	$ 11.1
Net value of assets as a percentage of total tuition benefits obligation	111.1%	105.9%

The most important assumptions used in the actuarial valuations include the following:

(1) The investment yield applied to expected future cash flows to determine present value was 1.31% as of September 30, 2012 and 1.38% as of September 30, 2011. This investment yield approximates the expected investment earnings over the lifetime of the present tuition benefit contracts. It is premised that expected benefit payments will be diversified in duration to allow MET to invest at the assumed investment yield of 1.31% and to also be able to liquidate its investments in order to meet future benefit payments while still earning the investment yield of 1.31%.

(2) For fiscal year 2011-12, the MET Board of Directors considered the relationship of tuition increases to the consumer price index in determining the tuition increase assumption of 7.10% for year 1 through year 5 and 4.50% for year 6 and beyond. For fiscal year 2011-12, the projected tuition increase was 7.10% compounded annually for all future years.

(3) There was no tax effect from federal income tax.

(4) MET will pay 110% of the MET weighted average tuition in benefits and refunds.

Presented below are the key assumptions used in the actuarial valuations for Plans B and C:

	Fiscal Years				
	2011-12	2010-11	2009-10	2008-09	2007-08
Tuition increase (year 1 through year 5)	7.10%	7.10%	6.50%	6.50%	7.30%
Tuition increase (year 6 and beyond)	4.50%	7.10%	6.50%	6.50%	7.30%
Present value discount rate	1.31%	1.38%	2.20%	2.20%	4.75%

The following summarizes the tuition benefits payable (in millions) as of and for the fiscal years ended September 30, 2012 and September 30, 2011:

Balance at September 30, 2010	$ 213.7
Provision for net increase (decrease) in present value of tuition benefits payable	18.9
Payments	(43.6)
Balance at September 30, 2011	$ 189.1
Provision for net increase (decrease) in present value of tuition benefits payable	(3.1)
Payments	(29.0)
Balance at September 30, 2012	$ 157.0

The amounts due within one year for tuition benefits payable for the fiscal years ended September 30, 2012 and September 30, 2011 are $61.0 million and $63.0 million, respectively. The actuarial assumptions described in this note have a significant impact on the tuition benefits liability. Actual results may differ from the assumptions utilized.

Note 5 Tax Status

On November 8, 1994, the U.S. Court of Appeals for the Sixth Circuit ruled that MET is an integral part of the State of Michigan; thus, the investment income realized by MET is not currently subject to federal income tax.

Distributions made in excess of contributions (whether to the refund designee or the beneficiary or to a college on behalf of the beneficiary) are taxable income to the refund designee or the beneficiary. After January 1, 2002, these excess distributions are no longer subject to federal income tax if used for qualified higher education expenses. The federal Pension Protection Act enacted in August 2006 provides permanent tax exemption for Internal Revenue Code Section 529 qualified tuition programs.

On August 20, 1996, the Small Business Job Protection Act of 1996 (known as the "1996 Tax Act") was signed into law. The 1996 Tax Act included a provision adding a new section to the Internal Revenue Code of 1986 defining "qualified tuition programs." A qualified tuition program is generally exempt from income tax but is subject to unrelated business income tax. MET has no unrelated business income.

In May 1997, MET submitted a request for ruling to the Internal Revenue Service (IRS) for verification that MET is in compliance with the 1996 Tax Act. On December 23, 1997, the IRS issued a favorable ruling, which confirms that MET meets the requirements for exemption from federal income tax as a state qualified tuition program described in Section 529 of the Internal Revenue Code.

Note 6 Risk Management

MET participates in the State of Michigan's (primary government) risk management program. The State is self-insured for most general liability and property losses; portions of its employee insurance benefit and bonding programs; and automobile liability, workers' compensation, and unemployment claims. The State Sponsored Group Insurance Fund and Risk Management Fund (internal service funds) have been established by the State to account for these self-insured risk management programs. As a participant, MET recognizes expenses for payments made to the State in a manner similar to purchasing commercial insurance. Charges to finance the self-insured programs are based on estimates of amounts needed to pay prior and current year claims as determined annually by the Department of Technology, Management, and Budget.

Note 7 Pension Plans

MET employees are State classified employees who are covered by the State Employees' Retirement System Defined Benefit or Defined Contribution Plans. Detail and data regarding the Plans' descriptions, accounting policies, vesting and eligibility requirements, actuarial cost methods and assumptions, funding status and requirements, and 10-year historical trend information are provided in the Plans' detailed financial reports. State statutes provide retired employees with other postemployment benefits, such as health, dental, vision, and life insurance coverage based on vesting and other requirements. The cost of retiree health care and other benefits is allocated by the Office of Retirement Services and funded on a pay-as-you-go basis.

MET was billed and paid an average 50.9% and 37.4% of its payroll costs for pension charges and retiree postemployment benefits in fiscal years 2011-12 and 2010-11, respectively. Beginning in fiscal year 2011-12, defined benefit plan members are required to contribute 4.0% of payroll to the pension plan. For the defined contribution plan, MET was required to contribute 4.0% of payroll with an additional match of up to 3.0% for fiscal year 2011-12. The Plans' detailed financial statements can be obtained from the Office of Retirement Services, Department of Technology, Management, and Budget, 7150 Harris Drive, P.O. Box 30171, Lansing, Michigan 48909.

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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
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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. Andy Dillon, State Treasurer and Chair
Michigan Education Trust Board of Directors
and
Ms. Robin R. Lott, Executive Director
Michigan Education Trust
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Dillon and Ms. Lott:

We have audited the statement of net assets; the statement of revenues, expenses, and changes in net assets; and the statement of cash flows of the Michigan Education Trust Plans B and C, a discretely presented component unit of the State of Michigan, as of and for the fiscal years ended September 30, 2012 and September 30, 2011 and have issued our report thereon dated December 17, 2012. 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.

<u>Internal Control Over Financial Reporting</u>
Management of the Michigan Education Trust is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Michigan Education Trust'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 Michigan Education Trust's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Michigan Education Trust's internal control over financial reporting.

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 financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined in the preceding paragraph. However, we identified certain deficiencies in internal control over financial reporting, as described in Finding 1, that we consider to be a significant deficiency in internal control over financial reporting. 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.

Compliance and Other Matters
As part of obtaining reasonable assurance about whether the Michigan Education Trust Plans B and C 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 Michigan Education Trust's preliminary response to the finding identified in our audit is included in the body of our report. We did not audit the Michigan Education Trust's 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 Michigan Education Trust Board of Directors, Michigan Education Trust management, and others within the Michigan Education Trust 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.

Sincerely,

Thomas H. McTavish

Thomas H. McTavish, C.P.A.
Auditor General
December 17, 2012

FINDING, RECOMMENDATION, AND AGENCY PRELIMINARY RESPONSE

FINDING

1. Segregation of Duties

The Michigan Education Trust (MET) had not implemented proper segregation of duties* over the administration of MET benefits. Without proper segregation of duties, MET contract administration staff may be able to bypass established security controls and act outside of their authority.

The Control Objectives for Information and Related Technology* (COBIT) framework, which is the State's standard for information technology practices, states that the agency should implement a division of roles and responsibilities that reduces the possibility for a single individual to compromise a critical process. In addition, the agency should establish standards that enforce appropriate segregation of duties and periodically review and update the standards.

MET uses the Prepaid Records Information Management Administrative (PRIMA) System for administering MET benefits, including processing MET applications, maintaining contract information, and calculating tuition payment information.

Our review of MET user access rights within the PRIMA System and inquiries of MET management regarding user monitoring procedures disclosed:

a. MET did not establish PRIMA user access rights to ensure least-privilege access* for MET staff. The principle of least-privilege access requires that users be granted the most restrictive set of privileges needed to perform their jobs. We noted:

(1) Six users had the ability to process a payment to an eligible educational institution. This access allowed the users to complete the entire process of making a payment to an educational institution without obtaining proper approval.

(2) Six users had the ability to reverse and reapply payments made on a contract. This access allowed the users to complete the entire process of reversing a payment that had been posted to a contract and reapply the payment to a different contract without obtaining proper approval.

** See glossary at end of report for definition.*

(3) Six users had the ability to process contract payments out of the PRIMA System suspense area. The PRIMA System suspense area is for contract payments received by MET that are missing information needed to apply the funds to the appropriate MET contract. This access allowed the users to complete the entire process of moving payments out of the suspense area without obtaining proper approval.

(4) Five users had the ability to process the addition of college credits to a contract. This access allowed the users to complete the entire process of adding credits to a contract without obtaining proper approval.

(5) Two users had the ability to process a refund payment. This access allowed the users to complete the entire process of refunding payments to contract holders without obtaining proper approval.

Preventing one individual from performing these transactions on his or her own without oversight will help ensure the propriety of all MET transactions.

b. MET did not have a formal process to regularly monitor individuals with conflicting PRIMA user access rights. Regular monitoring helps to ensure that individuals with conflicting access are not acting outside of their authority.

RECOMMENDATION

We recommend that MET implement proper segregation of duties over the administration of MET benefits.

AGENCY PRELIMINARY RESPONSE

MET agrees with the recommendation and informed us that it will develop a plan, in consultation with the system vendor, to establish an access rights process to ensure segregation of duties over the administration of MET benefits. MET user access changes to process reversal of funds, contract payments, addition of college credits, and refund payments will be made accordingly. MET estimates that these changes will be completed by June 2013.

GLOSSARY

Control Objectives for Information and Related Technology (COBIT)	A framework, control objectives, and audit guidelines published by the IT Governance Institute as a generally applicable and accepted standard for good practices for controls over information technology.
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.
FASB	Financial Accounting Standards Board.
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.
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.
IRS	Internal Revenue Service.

least-privilege access	Access that requires each subject in a system be granted the most restrictive set of privileges needed for the performance of authorized tasks. The application of this principle limits the damage that can result from accidental error or unauthorized use.
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 deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected, on a timely basis.
MET	Michigan Education Trust.
PRIMA System	Prepaid Records Information Management Administrative 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.
unqualified opinion	An auditor's opinion in which the auditor states that the financial statements presenting the basic financial information of the audited entity are fairly presented in conformity with the disclosed basis of accounting.

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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL