FINANCIAL AUDIT
OF THE

MICHIGAN EDUCATION TRUST PLAN D

(A Component Unit of the State of Michigan)

October 1, 2002 through September 30, 2003

"...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

Michigan

Office of the Auditor General

REPORT SUMMARY

Financial Audit

Michigan Education Trust Plan D

Fiscal Year Ended September 30, 2003

Report Number:
27-283-03

Released:
March 2004

A financial audit determines if the financial statements are fairly presented; considers internal control over financial reporting; and determines compliance with State compliance requirements material to the financial statements. This financial audit of the Michigan Education Trust (MET) Plan D 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 Plan D financial statements.

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Internal Control Over Financial Reporting

We did not report any findings related to internal control over financial reporting.

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Noncompliance Material to the Financial Statements

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

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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 members 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://www.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

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

March 9, 2004

Mr. Jay B. Rising, Chairman
Board of Directors
and
Ms. Robin R. McMillan, Executive Director
Michigan Education Trust
Treasury Building
Lansing, Michigan

Dear Mr. Rising and Ms. McMillan:

This is our report on the financial audit of the Michigan Education Trust (MET) Plan D for the period October 1, 2002 through September 30, 2003. MET is a component unit of the State of Michigan.

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 Plan D financial statements and notes to the financial statements. This report also contains our independent auditor's report on compliance and on internal control over financial reporting and a glossary of acronyms and terms.

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

AUDITOR GENERAL

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MICHIGAN EDUCATION TRUST PLAN D

GLOSSARY

INDEPENDENT AUDITOR'S REPORT

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

Independent Auditor's Report on the Financial Statements

November 14, 2003

Mr. Jay B. Rising, Chairman
Board of Directors
Michigan Education Trust
Treasury Building
Lansing, Michigan

Dear Mr. Rising:

We have audited the financial statements of the Michigan Education Trust Plan D as of and for the fiscal years ended September 30, 2003 and September 30, 2002, as identified in the table of contents. The Michigan Education Trust is a component unit of the State of Michigan. 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 1b, the financial statements present only the Michigan Education Trust Plan D and do not purport to, and do not, present fairly the financial position of the State of Michigan or its component units as of September 30, 2003 and September 30, 2002 and the changes in financial position and cash flows thereof 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 Plan D as of September 30, 2003 and September 30, 2002 and the changes in financial position and cash flows thereof for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 14, 2003 on our tests of the Michigan Education Trust's compliance with certain provisions of laws, regulations, contracts, and grants and on our consideration of its internal control over financial reporting. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

AUDITOR GENERAL

MANAGEMENT'S DISCUSSION AND ANALYSIS

This is a discussion and analysis of the financial performance of the Michigan Education Trust (MET) Plan D for the fiscal year ended September 30, 2003. MET is an Internal Revenue Code Section 529 prepaid tuition program and is a 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 financial statements are interrelated and represent the financial status of MET.

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 year.

The Statement of Cash Flows presents information related to cash inflows and outflows summarized by operating and investing activities.

Analysis of Financial Activities

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 MET management, is responsible for short-term and long-term investment of MET funds. The MET portfolio for Plan D may be invested up to 30% in equities with the remainder invested in short-term investments, U.S. government securities, and corporate bonds.

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. Students have nine years from the expected year of high school graduation to completely 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 against MET by students and purchasers.

Overall, MET Plan D experienced a 4% increase in new contract enrollment, which increases the asset value and future liabilities. MET received 4,462 new contracts with approximately $54 million in prepaid tuition amounts during fiscal year 2002-03.

Comparison of Current Year and Prior Year Results

Condensed Financial Information
From the Statement of Net Assets
As of September 30
(in thousands)

	2003	2002
Current assets	$ 59,941	$ 55,721
Noncurrent assets	213,987	143,319
Total Assets	$ 273,927	$ 199,040
Current liabilities	$ 3,274	$ 7,049
Noncurrent liabilities	280,752	204,865
Total Liabilities	$ 284,026	$ 211,914
Net Assets - Restricted	$ (10,099)	$ (12,874)
Total Net Assets	$ (10,099)	$ (12,874)

Overall, net assets increased by approximately $2.8 million.

Current assets increased primarily because of the increase in cash and cash equivalents. Cash and cash equivalents include short-term investments. This line item increased as of September 30, 2003 because some investments matured and the proceeds were not immediately reinvested in the long-term portfolio because of market volatility.

Noncurrent assets increased to reflect an increase in new contract prepaid tuition amounts received in fiscal year 2002-03, which included lump-sum and monthly purchase contracts.

The MET Plan D target portfolio is 70% invested in short-term investments, U.S. government securities, and corporate bonds and 30% invested in equities. The actual portfolio was 82.7% fixed income investments and 17.3% equity.

Current liabilities decreased in fiscal year 2002-03. Amounts due to MET Program (Plans B and C) decreased primarily because of an increase in salaries and other administrative expenses reimbursed to MET Plans B and C during fiscal year 2002-03. Accounts payable decreased because of a security purchased prior to October 1, 2002 that was settled in fiscal year 2002-03.

Noncurrent liabilities increased in fiscal year 2002-03. The tuition benefits payable increase reflects the changes in the actuarial present value of the future tuition obligation and increases for new contracts issued. Changes in the present value of the future tuition benefit obligation include the changes in the present value discount due to the passage of time, differences between actual experience and the actuarial assumptions utilized, and any changes in actuarial assumptions. Current and noncurrent tuition benefits payable increased to reflect the increase in lump-sum and monthly purchase contracts received and the actuarial present value of future tuition benefit obligations.

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

	2003	2002
Operating Revenues		
Interest and dividend income	$ 3,671	$ 1,972
Net realized and unrealized appreciation (depreciation) in the fair value of investments	7,821	(53)
Other miscellaneous income	283	273
Total Operating Revenues	$ 11,775	$ 2,193
Operating Expenses		
Salaries and other administrative expenses	$ 596	$ 597
Tuition benefit expenses	8,404	18,127
Total Operating Expenses	$ 9,000	$ 18,724
Operating Income (Loss)	$ 2,775	$ (16,532)
Nonoperating Revenues (Expenses)	$ 0	$ 0
Transfers	$ 0	$ 0
Increase (Decrease) in Net Assets	$ 2,775	$ (16,532)
Net assets - Beginning of fiscal year	(12,874)	3,658
Net assets - End of fiscal year	$ (10,099)	$ (12,874)

Net realized and unrealized appreciation (depreciation) in the fair value of investments increased primarily because of an increase in market value of investments in equities during the fiscal year and contributed to an overall increase of operating revenues in fiscal year 2002-03.

Salaries and other administrative expenses slightly decreased. This decrease is attributed to the decrease in the cost of marketing.

Tuition benefit expenses decreased because of the actuarially determined tuition benefit obligation. The primary reason for the decrease was related to the updating of the actuarial assumptions used by the Actuary to calculate the tuition benefit obligation.

The deficit in **net assets at the end of the fiscal year** decreased slightly from the prior fiscal year because of updated actuarial assumptions for interest earnings and tuition and fee increases, partially offset by an increase in tuition and fees from a year ago.

As stated in the Actuary's 2003 report, MET Plan D is 96.44% funded and is able to pay benefits through 2021 even if no new contracts are issued.

Condensed Financial Information
From the Statement of Cash Flows
Fiscal Year Ended September 30
(in thousands)

	2003	2002
Cash provided (used) by:		
Operating activities	$ 64,899	$ 48,196
Investing activities	(63,487)	(28,733)
Net increase (decrease) in cash	$ 1,412	$ 19,463
Cash and cash equivalents - Beginning of fiscal year	43,857	24,394
Cash and cash equivalents - End of fiscal year	$ 45,269	$ 43,857

Cash provided by operating activities increased primarily because of an increase in new lump sum contracts received during fiscal year 2002-03.

Cash used by investing activities increased because of the increased amount of cash available for investment purchases.

The stock market was volatile for the fourth consecutive year, which negatively impacted Plan D. However, open enrollment for the year resulted in a 35% increase in prepaid tuition amounts received compared to amounts received in the prior fiscal year. Prepaid tuition receipts translate to an increase in the tuition liability; however, the actuarial soundness of MET is based in part on new contracts being purchased.

Factors Impacting Future Periods

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

MET enrollment for 2004 will be held December 15, 2003 through April 15, 2004. New enrollments will increase cash, future tuition benefits payable, and the asset base of MET Plan D.

FINANCIAL STATEMENTS

MICHIGAN EDUCATION TRUST PLAN D
Statement of Net Assets
As of September 30

	2003	2002
ASSETS		
Current Assets:		
Cash and cash equivalents (Note 3)	$ 45,268,985	$ 43,856,676
Tuition contracts receivable (Note 4)	13,665,680	11,600,324
Amounts due from primary government		266
Interest and dividends receivable	1,006,187	263,243
Total Current Assets	$ 59,940,852	$ 55,720,509
Noncurrent Assets:		
Investments (Note 3)	174,030,438	107,675,555
Tuition contracts receivable (Note 4)	39,956,152	35,643,849
Total Assets	$ 273,927,442	$ 199,039,913
LIABILITIES		
Current Liabilities:		
Amounts due to MET Program (Plans B and C)	$ 574,475	$ 595,868
Accounts payable - Vendors		4,953,125
Tuition benefits payable (Note 5)	2,700,000	1,500,000
Total Current Liabilities	$ 3,274,475	$ 7,048,993
Noncurrent Liabilities:		
Tuition benefits payable (Note 5)	280,751,984	204,864,683
Total Liabilities	$ 284,026,459	$ 211,913,676
NET ASSETS		
Net Assets - Restricted	$ (10,099,017)	$ (12,873,763)
Total Net Assets	$ (10,099,017)	$ (12,873,763)

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

MICHIGAN EDUCATION TRUST PLAN D
Statement of Revenues, Expenses, and Changes in Net Assets
Fiscal Year Ended September 30

	2003	2002
OPERATING REVENUES		
Interest and dividend income	$ 3,671,497	$ 1,972,296
Net realized and unrealized appreciation (depreciation) in the fair value of investments	7,820,679	(52,851)
Other miscellaneous income	283,037	273,073
Total Operating Revenues	$ 11,775,213	$ 2,192,518
OPERATING EXPENSES		
Salaries and other administrative expenses	$ 596,257	$ 597,340
Tuition benefit expenses	8,404,209	18,126,816
Total Operating Expenses	$ 9,000,467	$ 18,724,156
Operating Income (Loss)	$ 2,774,746	$ (16,531,638)
Nonoperating Revenues (Expenses)	$ 0	$ 0
Transfers	$ 0	$ 0
Increase (Decrease) in Net Assets	$ 2,774,746	$ (16,531,638)
Net assets - Beginning of fiscal year	(12,873,763)	3,657,875
Net assets - End of fiscal year	$ (10,099,017)	$ (12,873,763)

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

MICHIGAN EDUCATION TRUST PLAN D
Statement of Cash Flows
Fiscal Year Ended September 30

	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Contract receipts	$ 65,467,274	$ 47,959,932
Interest and dividends received	2,928,553	1,998,046
Contract payments	(3,161,841)	(1,291,888)
Administrative and other expenses paid	(617,650)	(743,289)
Application and other fees collected	283,037	273,073
Net cash provided (used) by operating activities	$ 64,899,373	$ 48,195,874
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investment securities	$ (102,835,218)	$ (55,012,191)
Proceeds from sale and maturities of investment securities	39,348,153	26,279,431
Net cash provided (used) by investing activities	$ (63,487,064)	$ (28,732,760)
Net cash provided (used) - All activities	$ 1,412,309	$ 19,463,114
Cash and cash equivalents - Beginning of fiscal year	43,856,676	24,393,562
Cash and cash equivalents - End of fiscal year	$ 45,268,985	$ 43,856,676
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED (USED) BY FROM OPERATING ACTIVITIES		
Operating income (loss)	$ 2,774,746	$ (16,531,638)
Adjustments to reconcile operating income (loss) to net cash provided from operating activities:		
Unrealized and realized (gains) losses	(7,820,679)	52,851
Changes in assets and liabilities:		
Tuition contracts receivable	(6,377,659)	(17,937,015)
Interest and dividends receivable	(742,944)	25,750
Amounts due from primary government		(266)
Amounts due to MET Program (Plans B and C)	(21,393)	(145,683)
Tuition benefits payable	77,087,301	82,731,875
Net cash provided (used) by operating activities	$ 64,899,373	$ 48,195,874

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

Notes to the Financial Statements

Note 1 Basis of Presentation and Reporting Entity

a. Basis of Presentation

The financial statements of the Michigan Education Trust (MET) Plan D have been prepared in accordance with generally accepted accounting principles applicable to governments.

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 Board of Directors consisting of 9 members, including 8 public members who are appointed by the Governor with the advice and consent of the Senate and 1 ex-officio member (the State Treasurer, acting as chairperson). MET is administratively located within the Department of Treasury. The State Treasurer, as agent for MET, 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 Plan D. 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 in conformity with generally accepted accounting principles applicable to governments.

Act 316, P.A. 1986, 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 actuarial 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.

As of September 30, 2003, there have been 10 enrollment periods for MET. The 1988, 1989, and 1990 enrollments are known as Plans B and C. The 1995, 1997, 1998, 1999, 2000, 2002, and 2003 enrollments are known as Plan D. The Plan D enrollments are accounted for and reported separately from the Plans B and C enrollments. This report covers the Plan D enrollments. A separate financial report and actuarial valuation of Plans B and C 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 generally accepted accounting principles applicable to governments. 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. Tuition benefit expense represents accretion of the tuition benefits obligation (see Note 5).

As allowed by 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.

b. Assets, Liabilities, and Net Assets

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.

Cash and Investments: MET's deposits and investments are held in a fiduciary capacity by the State Treasurer. Act 316, P.A. 1986, 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 market value (see Note 3).

Act 316, P.A. 1986, requires all deposits of MET to be secured by obligations of the United States or of the State. The market value of these obligations must at all times be equal to or greater than the amount of the deposits of MET, and all banks and trust companies are authorized to give such security for such deposits.

Tuition Contracts Receivable: The present value of the future monthly purchase contract payments is recorded as a current and noncurrent asset of MET. The discount rate applied to expected future cash flows to determine present value is 8.10%.

Liabilities: The actuarial present value of the future tuition obligation is recorded as a current and noncurrent liability of MET (see Note 5).

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 obligation and expenses (see Note 5). 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. 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 this act and shall not be loaned or otherwise transferred or used by the state for any purpose other than the purposes of this act."

Note 3 Deposits and Investments

a. General Information

GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, requires certain disclosures regarding policies and practices with respect to deposits and investments and the custodial credit risk associated with them.

Deposits: In accordance with GASB Statement No. 3, deposits are classified into three categories of credit risk, as follows:

Category 1: Insured or collateralized with securities held by the entity or by its agent in the entity's name.

Category 2: Collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name.

Category 3: Uncollateralized, including bank balances that are collateralized with securities held by the pledging financial institution or by its trust department or agent but not in the entity's name.

Investments: In accordance with GASB Statement No. 3, investments are also classified into three categories of credit risk, as follows:

Category 1: Insured or registered, or securities held by the entity or its agent in the entity's name.

Category 2: Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the entity's name.

Category 3: Uninsured and unregistered, with securities held by the counterparty or by its trust department or agent but not in the entity's name.

b. <u>Deposits</u>

At fiscal year-end, the carrying amount of MET's deposits for Plan D was $1,915,007. The deposits were reflected in the accounts of the banks at $1,915,007. The September 30, 2003 balances were covered by federal depository insurance or collateral held with MET's agent in MET's name and, accordingly, classified in GASB credit risk category 1.

c. <u>Investments</u>

The following table shows the carrying amounts and market values of investments for Plan D by investment type and in total (in millions) at September 30, 2003:

Investments	GASB Credit Risk Category 1	2	3	Not Categorized	Total Carrying Value	Market Value
Commercial paper	$ 43.4	$	$	$	$ 43.4	$ 43.4
Government securities	118.2				118.2	118.2
Corporate bonds and notes	18.2				18.2	18.2
Mutual funds				37.6	37.6	37.6
Total Investments	$ 179.8	$ 0	$ 0	$ 37.6	$ 217.4	$ 217.4

Less Investments Reported as Cash and Cash Equivalents on Statement of Net Assets	(43.4)
Total Investments Per Statement of Net Assets	$ 174.0
<u>As Reported on Statement of Net Assets</u>	
Cash and cash equivalents (net of deposits, see Note 3b)	$ 43.4
Noncurrent investments	174.0
Total Investments	$ 217.4

Note 4 <u>Tuition Contracts Receivable</u>

The following table summarizes tuition contracts receivable for monthly purchase contracts as of September 30:

	2003	2002
Tuition contracts receivable	$ 67,287,512	$ 57,842,647
Present value discount	(13,665,680)	(10,598,474)
Net Tuition Contracts Receivable	$ 53,621,832	$ 47,244,173

Note 5 Tuition Benefits Payable

The standardized measurement of the total tuition benefits obligation of MET is the actuarial present value of the future tuition obligation. This valuation method reflects the present value of estimated tuition benefits that will be paid in future years and is adjusted for the effects of projected tuition increases and termination of MET contracts. The following table shows the total tuition benefits obligation of MET as of September 30:

	2003	2002
Market value of net assets, excluding tuition benefits obligation	$ 273,352,967	$ 193,490,920
Present value of future benefits payable and expenses, assuming MET earns 8.1% (7.0% for 2002)	$ 283,451,984	$ 206,364,683
Net assets in excess of tuition benefits obligation	$ (10,099,017)	$ (12,873,763)
Net assets as a percentage of tuition benefits obligation	96%	94%

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

(1) The discount rate applied to expected future cash flows to determine present value is 8.1%. This discount rate approximates the expected investment yield over the lifetime of the present tuition benefit contracts.

(2) The projected tuition increase is 7.0% compounded annually for the next five years and 7.30% for the balance of the period. The MET Board of Directors continued with a two-tier formula for adjusting the tuition increase assumption. The short-term increase assumption of 7.0% (five years through 2009) was based on an extrapolation of recent experience. The Board also considered the relationship of tuition increases to the consumer price index in determining the long-term tuition increase assumption of 7.30%.

(3) There was no tax effect from the 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 valuation for Plan D:

	Fiscal Years				
	2002-03	2001-02	2000-01	1999-2000	1998-99
Tuition increase	7.00%	5.84%	5.71%	5.81%	6.30%
Tuition increase - Long-Term	7.30%	7.30%	7.30%	7.30%	7.30%
Present value discount rate	8.10%	7.00%	7.00%	6.83%	6.83%

The following summarizes the tuition benefits payable as of and for the fiscal years ended September 30, 2003 and September 30, 2002:

Balance at October 1, 2001	$	123,632,808
Expense provision		84,023,763
Payments		(1,291,888)
Balance at September 30, 2002	$	206,364,683
Expense provision		80,249,142
Payments		(3,161,841)
Balance at September 30, 2003	$	283,451,984

The amounts due within one year for the fiscal years ended September 30, 2003 and September 30, 2002 are $2,700,000 and $1,500,000, respectively. The actuarial assumptions described in this note have a significant impact on the tuition benefit liability. Actual results may differ from the assumptions utilized.

Note 6 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 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 tax exemption is scheduled to expire in 2010.

On August 20, 1996, the Small Business Job Protection Act of 1996 (known as the "1996 Tax Act") was signed into law, which included a provision adding a new section to the Internal Revenue Code of 1986 defining "qualified state tuition programs." A qualified state 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 qualified state tuition program described in section 529 of the Internal Revenue Code.

Note 7 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 Management and Budget.

Note 8 Pension Plans

MET employee's are State classified employees who are covered by the State Employees' Retirement System plans. Detail and data regarding the plan 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 *State of Michigan Comprehensive Annual Financial Report* and the plans' detailed financial reports, issued by the Office of Retirement Services, Department of Management and Budget.

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND INTERNAL CONTROL

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 Compliance and on Internal Control Over Financial Reporting

November 14, 2003

Mr. Jay B. Rising, Chairman
Board of Directors
Michigan Education Trust
Treasury Building
Lansing, Michigan

Dear Mr. Rising:

We have audited the financial statements of the Michigan Education Trust Plan D as of and for the fiscal year ended September 30, 2003 and September 30, 2002, as identified in the table of contents, and have issued our report thereon dated November 14, 2003. The Michigan Education Trust is a component unit of the State of Michigan. 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.

Compliance

As part of obtaining reasonable assurance about whether the Michigan Education Trust's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 that are required to be reported under *Government Auditing Standards.*

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Michigan Educations Trust's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Michigan Education Trust's Board of Directors and management and the Legislature 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

GLOSSARY

Glossary of Acronyms and Terms

financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are fairly presented in conformity with the disclosed basis of accounting.
GASB	Governmental Accounting Standards Board.
internal control	A process, effected by management, designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
IRS	Internal Revenue Services.
material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the results of operations or cash flows in conformity with the disclosed basis of accounting.
material weakness	A reportable condition related to the design or operation of internal control that does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and/or financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
MET	Michigan Education Trust.
reportable condition	A matter coming to the auditor's attention relating to a significant deficiency in the design or operation of internal control that, in the auditor's judgment, could adversely affect

the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial schedules and/or financial statements.

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