MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

FINANCIAL AUDIT
OF THE

MICHIGAN EDUCATION TRUST PLAN D
(A Component Unit of the State of Michigan)

October 1, 2004 through September 30, 2006

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

271-0283-07

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 Plan D

(A Component Unit of the State of Michigan)

October 1, 2004 through September 30, 2006

Report Number:
271-0283-07

Released:
March 2007

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

March 30, 2007

Mr. Robert J. Kleine, Chair
Board of Directors
and
Ms. Robin R. Lott, Executive Director
Michigan Education Trust
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine and Ms. Lott:

This is our report on the financial audit of the Michigan Education Trust (MET) Plan D for the period October 1, 2004 through September 30, 2006. 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 internal control over financial reporting and on compliance and other matters 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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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. Robert J. Kleine, Chair
Board of Directors
and
Ms. Robin R. Lott, Executive Director
Michigan Education Trust
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine and Ms. Lott:

We have audited the statement of net assets (deficit); the statement of revenues, expenses, and changes in net assets (deficit); and the statement of cash flows of the Michigan Education Trust Plan D, a component unit of the State of Michigan, as of and for the fiscal years ended September 30, 2006 and September 30, 2005. 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 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, 2006 and September 30, 2005 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, 2006 and September 30, 2005 and the changes in financial position and 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 22, 2006 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.

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 required supplementary information. However, we did not audit the information and express no opinion on it.

AUDITOR GENERAL

December 22, 2006

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 years ended September 30, 2006 and September 30, 2005. MET is an Internal Revenue Code Section 529 qualified 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 (deficit) includes the assets, liabilities, and net assets (deficit) at the end of the fiscal year.

The statement of revenues, expenses, and changes in net assets (deficit) 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.

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 70% 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. 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.

MET Plan D received 3,338 new contracts and $52 million in prepaid tuition amounts during fiscal year 2005-06. In fiscal year 2004-05, MET received 3,396 new contracts and $43 million in prepaid tuition amounts. In fiscal year 2003-04, MET received 2,620 new contracts and $31 million in prepaid tuition amounts.

Comparison of Current Year and Prior Year Results

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

	2006	2005	2004
Current assets	$ 43,241	$ 49,510	$ 70,437
Noncurrent assets	443,713	352,568	262,177
Total Assets	$ 486,954	$ 402,078	$ 332,614
Current liabilities	$ 11,561	$ 7,281	$ 5,045
Noncurrent liabilities	520,486	439,133	363,431
Total Liabilities	$ 532,048	$ 446,415	$ 368,476
Net Assets (Deficit) - Unrestricted	$ (45,094)	$ (44,337)	$ (35,863)
Total Net Assets (Deficit)	$ (45,094)	$ (44,337)	$ (35,863)

Total net assets decreased by $0.8 million in fiscal year 2005-06 and by $8.5 million in fiscal year 2004-05. The net assets decreased primarily because the asset performance was lower than expected. The decrease in net assets was somewhat offset by lower-than-expected tuition and fee increases and longer-than-expected delays by beneficiaries in the use of their contracts.

Current assets decreased by $6.3 million in fiscal year 2005-06 primarily because of the decrease in cash and cash equivalents. Cash and cash equivalents include short-term investments. The decrease was because the proceeds were reinvested in the long-term portfolio. Current assets decreased by $20.9 million in fiscal year 2004-05 primarily because of the decrease in cash and cash equivalents. The decrease resulted when some investments matured and the proceeds were reinvested immediately in the long-term portfolio.

Noncurrent assets increased by $91.1 million in fiscal year 2005-06 and by $90.4 million in fiscal year 2004-05. These increases reflect an increase in new contract prepaid tuition amounts received in fiscal year 2005-06 and in fiscal year 2004-05, which included lump-sum and monthly purchase contracts.

The MET Plan D target portfolio was 30% invested in short-term investments, U.S. government securities, and corporate bonds and 70% invested in equities. The actual portfolio was 42.91% fixed income investments and 57.09% equity.

Current liabilities increased by $4.3 million in fiscal year 2005-06 and $2.2 million in fiscal year 2004-05. Amounts due to MET Program (Plans B and C) increased primarily because of an increase in administrative expenses during fiscal year 2005-06 and fiscal year 2004-05.

Noncurrent liabilities increased by $81.4 million in fiscal year 2005-06 and by $75.7 million in fiscal year 2004-05. The tuition benefits payable increases reflect the changes in the actuarial present value of the future tuition benefits obligation and increases for new contracts issued. Changes in the present value of the future tuition benefits obligation include the changes in the present value discount because of 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 benefits obligations.

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

	2006	2005	2004
Operating Revenues			
Interest and dividends income	$ 10,122	$ 8,534	$ 5,674
Net realized and unrealized appreciation (depreciation) in the fair value of investments	18,020	6,928	7,900
Other miscellaneous income	110	108	197
Total Operating Revenues	$ 28,251	$ 15,570	$ 13,771
Operating Expenses			
Salaries and other administrative expenses	$ 1,482	$ 1,285	$ 1,056
Tuition benefit expense	27,526	22,760	38,479
Total Operating Expenses	$ 29,008	$ 24,044	$ 39,534
Operating Income (Loss)	$ (757)	$ (8,474)	$ (25,764)
Nonoperating Revenues (Expenses)	$ 0	$ 0	$ 0
Transfers	$ 0	$ 0	$ 0
Increase (Decrease) in Net Assets	$ (757)	$ (8,474)	$ (25,764)
Net Assets (Deficit) - Beginning of Fiscal Year	(44,337)	(35,863)	(10,099)
Net Assets (Deficit) - End of Fiscal Year	$ (45,094)	$ (44,337)	$ (35,863)

Interest and dividends income increased by $1.6 million in fiscal year 2005-06 and by $2.9 million in fiscal year 2004-05 primarily because of an increase in investments.

Net realized and unrealized appreciation (depreciation) in the fair value of investments increased by $11.1 million in fiscal year 2005-06 primarily because of an increase in the market value of investments in equities during the fiscal year. The decrease of $1.0 million in fiscal year 2004-05 was primarily because of a decrease in market value of investments in U.S. government securities and corporate bonds during the fiscal year and contributed to an overall decrease in operating revenues in fiscal year 2004-05.

Salaries and other administrative expenses increased by approximately $198,000 in fiscal year 2005-06 and by $229,000 in fiscal year 2004-05. These increases are attributed to the increase in printing, shipping, wage, and salary costs and other administrative expenses.

Tuition benefit expenses increased by $4.8 million in fiscal year 2005-06 and decreased by $15.7 million in fiscal year 2004-05 because of the actuarially determined tuition benefits obligation. The primary reason for both the increase and the decrease related to the updating of actuarial assumptions used by the actuary to calculate the tuition benefits obligation.

The deficit in **net assets - end of fiscal year** increased by $0.8 million in fiscal year 2005-06 and by $8.5 million in fiscal year 2004-05. The increases were primarily because interest earnings were less than expected and tuition and fee increases were greater than expected.

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

	2006	2005	2004
Net Cash Provided (Used) by:			
Operating activities	$ 65,677	$ 60,891	$ 50,998
Investing activities	(72,292)	(86,170)	(38,410)
Net Cash Provided (Used) - All Activities	$ (6,614)	$ (25,279)	$ 12,588
Cash and Cash Equivalents - Beginning of Fiscal Year	32,579	57,857	45,269
Cash and Cash Equivalents - End of Fiscal Year	$ 25,964	$ 32,579	$ 57,857

Cash provided by operating activities increased by $4.8 million in fiscal year 2005-06 primarily because of an increase in contract enrollment from fiscal year 2004-05. The increase of $9.9 million in fiscal year 2004-05 was primarily because of an increase in contract enrollment from fiscal year 2003-04.

Cash used by investing activities decreased by $13.9 million in fiscal year 2005-06 because of the decreased amount of cash available for investment purposes. This line item increased by $47.8 million in fiscal year 2004-05 because of the increased amount of cash available for investing purposes.

Open enrollment for fiscal year 2005-06 resulted in a 20.6% increase in prepaid tuition amounts received compared to amounts received in the prior fiscal year. Open enrollment during fiscal year 2004-05 resulted in a 38.7% increase in prepaid tuition amounts received compared to amounts in the prior fiscal year. Prepaid tuition receipts translate into 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 2005 was held from September 1, 2004 through June 15, 2005. Enrollment for 2006 was held from September 1, 2005 through August 31, 2006. The first 2007 enrollment period was October 1, 2006 through January 31, 2007. The second 2007 enrollment period will begin April 1, 2007 and will end July 31, 2007. New enrollments will increase cash, future tuition benefits payable, and the asset base of MET Plan D.

As stated in the actuary's report, MET Plan D is 91.5% funded and is expected to pay benefits through 2022 even if no new contracts are issued. The MET Board of Directors reviews asset allocation and investment performance on a quarterly basis. At the beginning of the fiscal year, the Board changed the long-term investment portfolio strategy to address the unfunded liability issue. The new MET Plan D target portfolio for investment is now 30% in fixed income securities (short-term investments, U.S. government securities, and corporate bonds) and 70% in equities.

FINANCIAL STATEMENTS

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

	2006	2005
ASSETS		
Current Assets:		
Cash and cash equivalents (Note 3)	$ 25,964,477	$ 32,578,805
Tuition contracts receivable (Note 4)	15,531,557	15,218,470
Interest and dividends receivable	1,744,510	1,712,343
Total Current Assets	$ 43,240,545	$ 49,509,618
Noncurrent Assets:		
Investments (Note 3)	403,749,093	313,437,541
Tuition contracts receivable (Note 4)	39,964,041	39,130,487
Total Assets	$ 486,953,679	$ 402,077,645
LIABILITIES		
Current Liabilities:		
Amounts due to MET Program (Plans B and C)	$ 1,561,054	$ 1,281,486
Tuition benefits payable (Note 5)	10,000,000	6,000,000
Total Current Liabilities	$ 11,561,054	$ 7,281,486
Noncurrent Liabilities:		
Tuition benefits payable (Note 5)	520,486,479	439,133,146
Total Liabilities	$ 532,047,533	$ 446,414,632
NET ASSETS		
Net Assets (Deficit) - Unrestricted (Note 5)	$ (45,093,854)	$ (44,336,986)
Total Net Assets (Deficit)	$ (45,093,854)	$ (44,336,986)

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 (Deficit)
Fiscal Years Ended September 30

	2006	2005
OPERATING REVENUES		
Interest and dividends income	$ 10,121,542	$ 8,534,064
Net realized and unrealized appreciation (depreciation) in the fair value of investments	18,020,022	6,927,548
Other miscellaneous income	109,853	108,472
Total Operating Revenues	$ 28,251,418	$ 15,570,084
OPERATING EXPENSES		
Salaries and other administrative expenses	$ 1,482,496	$ 1,284,831
Tuition benefit expenses	27,525,790	22,759,660
Total Operating Expenses	$ 29,008,286	$ 24,044,492
Operating Income (Loss)	$ (756,868)	$ (8,474,407)
Nonoperating Revenues (Expenses)	$ 0	$ 0
Transfers	$ 0	$ 0
Increase (Decrease) in Net Assets	$ (756,868)	$ (8,474,407)
Net Assets (Deficit) - Beginning of Fiscal Year	(44,336,986)	(35,862,579)
Net Assets (Deficit) - End of Fiscal Year	$ (45,093,854)	$ (44,336,986)

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

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

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Contract receipts	$ 66,911,804	$ 58,944,556
Interest and dividends received	10,089,375	8,070,628
Contract payments	(10,230,902)	(5,183,444)
Administrative and other expenses paid	(1,202,927)	(1,048,819)
Application and other fees collected	109,853	108,472
Net Cash Provided (Used) From Operating Activities	$ 65,677,204	$ 60,891,393
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investment securities	$ (87,310,638)	$ (101,151,512)
Proceeds from sale and maturities of investment securities	15,019,105	14,981,602
Net Cash Provided (Used) by Investing Activities	$ (72,291,533)	$ (86,169,910)
Net Cash Provided (Used) - All Activities	$ (6,614,329)	$ (25,278,516)
Cash and Cash Equivalents - Beginning of Fiscal Year	32,578,806	57,857,322
Cash and Cash Equivalents - End of Fiscal Year	$ 25,964,477	$ 32,578,805
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
Operating income (loss)	$ (756,868)	$ (8,474,407)
Adjustments to reconcile operating income (loss) to net cash provided by operating activities:		
Unrealized and realized (gains) losses	(18,020,022)	(6,927,548)
Changes in assets and liabilities:		
Tuition contracts receivable	(1,146,641)	(1,181,402)
Interest and dividends receivable	(32,167)	(463,436)
Amounts due to MET Program (Plans B and C)	279,569	236,082
Tuition benefits payable	85,353,333	77,702,104
Net Cash Provided (Used) by Operating Activities	$ 65,677,204	$ 60,891,393

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) 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 9-member Board of Directors that consists of 1 ex-officio member (the State Treasurer, acting as chairperson) 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 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 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.

As of September 30, 2006, there have been 13 enrollment periods 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, and 2006 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 expenses represent accretion of the tuition benefits obligation (see Note 5).

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.

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. In fiscal year 2005-06, the discount rate applied to expected future cash flows to determine present value is 7.35%. In fiscal year 2004-05, the discount rate was 7.25%.

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

Net Assets (Deficit): MET's net assets represent the investment appreciation and the investment revenue in excess of (or less than) the actuarial present value of the future tuition benefits obligation and expenses (see Note 5). Positive 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. Negative net assets are unrestricted. The enabling legislation for MET is Act 316, P.A. 1986. Section 17 of the Act indicates:

> 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

During the fiscal year ended September 30, 2005, MET adopted GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, which requires certain disclosures regarding policies and practices with respect to the risks associated with them. The interest rate risk, the credit risk, the custodial credit risk, the concentration of credit risk, and the foreign currency 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.

At the end of fiscal year 2005-06, the carrying amount of MET's deposits for Plan D and the amount reflected in the accounts of the banks was $2,900,982. At the end of fiscal year 2004-05, the carrying amount of MET's deposits for Plan D and the amount reflected in the accounts of the banks was $3,630,981. The September 30, 2006 and September 30, 2005 balances were covered by federal depository insurance or collateral held with MET's agent in MET's name and, therefore, are 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 an investment or deposit. As of September 30, 2006 and September 30, 2005, 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 Plan D by investment type and in total (in millions) at September 30, 2006:

		Investment Maturities			
	Fair Value	Less Than 1 Year	1 to 5 Years	6 to 10 Years	More Than 10 Years
Investments:					
Commercial paper	$ 23.1	$ 23.1	$	$	$
U.S. Treasury bonds	11.1	2.1	9.0		
U.S. agencies - backed	1.6				1.6
U.S. agencies - sponsored	93.0		27.1	50.3	15.6
Corporate bonds and notes	54.3		30.3	14.1	9.9
*Mutual funds	243.7				
Total Investments	$ 426.8	$ 25.2	$ 66.4	$ 64.4	$ 27.0
Less investments reported as "cash equivalents" on statement of net assets	(23.1)				
Total Investments	$ 403.7				
<u>As Reported on the Statement of Net Assets</u>					
Noncurrent restricted investments	$ 403.7				
Total Investments	$ 403.7				

*Mutual funds have no fixed income or duration and, therefore, are not segmented for time.

The following table shows the fair value of investments for Plan D by investment type and in total (in millions) at September 30, 2005:

		Investment Maturities			
	Fair Value	Less Than 1 Year	1 to 5 Years	6 to 10 Years	More Than 10 Years
Investments:					
Commercial paper	$ 29.0	$ 29.0	$	$	$
U.S. Treasury bonds	12.7	1.9	10.3	.5	
U.S. agencies - backed	2.0				2.0
U.S. agencies - sponsored	93.6		19.9	47.9	25.8
Corporate bonds and notes	66.6		1.8	54.5	10.2
*Mutual funds	138.6				
Total Investments	$ 342.4	$ 30.8	$ 32.1	$ 102.8	$ 38.1
Less investments reported as "cash equivalents" on statement of net assets	(29.0)				
Total Investments	$ 313.4				
As Reported on the Statement of Net Assets					
Noncurrent restricted investments	$ 313.4				
Total Investments	$ 313.4				

*Mutual funds have no fixed income or duration and, therefore, are not segmented for time.

(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: AAA, AA, A, and BBB from Standard & Poor's and Aaa, Aa, A, and Baa from Moody's Investors Service. As of September 30, 2006, the fair value and credit quality ratings of investments are as follows:

		Credit Quality Rating	
Investment	Fair Value	Standard & Poor's	Moody's Investors Services
CSX Transportation	$ 1,759,113	A	A1
Anheuser Busch	2,754,132	A+	A1
Burlington Northern	1,259,232	A+	Aa2
Cargill Inc.	4,887,875	A+	A2
General Electric Capital Corp.	17,800,930	AAA	Aaa
Pfizer Inc.	2,364,145	AAA	Aaa
Seariver Maritime	18,513,056	AAA	Aaa
Precision Castparts	4,950,397	BBB	Baa2
Federal Home Loan Mortgage Corp.	9,858,480	AAA	Aaa
Federal Farm Credit Bank	4,877,258	AAA	Aaa
Federal Home Loan Bank	78,284,878	AAA	Aaa
Government National Mortgage Association	1,583,875	Backed	Backed
United States Treasury	11,160,490	Backed	Backed
The Vanguard Group	243,695,232	Not rated	Not rated
Total Fair Value	$ 403,749,093		

As of September 30, 2005, the market value and credit quality ratings of investments are as follows:

		Credit Quality Rating	
Investment	Fair Value	Standard & Poor's	Moody's Investors Services
CSX Transportation	$ 1,828,475	A	A1
Anheuser Busch	2,954,400	A+	A1
Burlington Northern	1,289,693	A+	Aa3
Cargill Inc.	4,989,840	A+	A2
General Electric Capital Corp.	18,065,969	AAA	Aaa
Pfizer Inc.	2,469,725	AAA	Aaa
Seariver Maritime	21,413,913	AAA	Aaa
General Motors Acceptance Corp.	8,480,822	BB	Ba1
Precision Castparts	5,063,800	BBB	Baa3
Federal Home Loan Mortgage Corp.	9,970,010	AAA	Aaa
Federal Farm Credit Banks	4,929,028	AAA	Aaa
Federal Home Loan Bank	78,685,902	AAA	Aaa
Government National Mortgage Association	2,036,391	Backed	Backed
United States Treasury	12,702,270	Backed	Backed
The Vanguard Group	138,557,303	Not rated	Not rated
Total Fair Value	$ 313,437,541		

(3) Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of 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 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 concentration of credit risk. At September 30, 2006, MET had the following investments that represented 5% or more of total investments:

Investment	Fair Value	Credit Quality Rating	
		Standard & Poor's	Moody's Investors Service
Federal Home Loan Bank	$78,284,878	AAA	Aaa

At September 30, 2005, MET had the following investments that represented 5% or more of total investments:

Investment	Fair Value	Credit Quality Rating	
		Standard & Poor's	Moody's Investors Services
Federal Home Loan Bank	$78,685,902	AAA	Aaa
General Electric Capital Corp.	$18,065,969	AAA	Aaa
Seariver Maritime	$21,413,913	AAA	Aaa

(5) Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of investments or deposits. As of September 30, 2006 and September 30, 2005, MET had no foreign investments.

Note 4 Tuition Contracts Receivable

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

	2006	2005
Tuition contracts receivable	$ 55,495,598	$ 69,567,427
Present value discount	(15,531,557)	(15,218,470)
Net Tuition Contracts Receivable	$ 39,964,041	$ 54,348,957

Note 5 Tuition Benefits Payable and Net Assets (Deficit)

The standardized measurement of the total tuition benefits obligation of MET is the actuarial present value of the future tuition benefits 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 obligations of MET as of September 30:

	2006	2005
Actuarially determined net value of assets	$ 485,392,625	$ 400,796,160
Present value of total tuition benefits obligation	530,486,479	445,133,146
Net Value of Assets in Excess of Tuition Benefits Obligation	$ (45,093,854)	$ (44,336,986)
Net value of assets as a percentage of total tuition benefits obligation	91.5%	90.0%

The deficit in net assets is a direct result of the future tuition benefits obligation exceeding the value of assets (unfunded tuition benefit liability). The tuition benefits obligation is calculated from future assumptions and actual tuition rates and the expected and actual selection of higher education institutions beneficiaries attend. Differences between future assumptions and actual investment returns and tuition increases will affect the net assets or unfunded tuition liability.

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 was 7.35% for fiscal year 2005-06 and 7.25% for fiscal year 2004-05. This discount rate approximates the expected investment yield over the lifetime of the present tuition benefit contracts.

(2) For fiscal year 2005-06, the projected tuition increase was 7.30% compounded annually for all future years. The MET Board of Directors considered the relationship of tuition increases to the consumer price index in determining the tuition increase assumption of 7.30%. The assumption was changed from the fiscal year 2004-05 assumptions. For

fiscal year 2004-05, the Board used a two-tier formula for adjusting the tuition increase assumption. The projected tuition increase was 7.00% compounded annually for the next five years and 7.30% for the balance of the periods. The short-term increases assumption of 7.00% (five years through 2011) 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%. The fiscal year 2004-05 assumptions were unchanged from the prior year.

(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 Plan D:

	Fiscal Years				
	2005-06	2004-05	2003-04	2002-03	2001-02
Tuition increase	7.30%	7.00%	7.00%	7.00%	5.84%
Tuition increase - long-term	7.30%	7.30%	7.30%	7.30%	7.30%
Present value discount rate	7.35%	7.25%	7.25%	8.10%	7.00%

The following summarizes the tuition benefits payable as of and for the fiscal years ended September 30, 2006 and September 30, 2005:

Balance at October 1, 2004	$	367,431,042
Expense provision		82,885,548
Payments		(5,183,444)
Balance at September 30, 2005	$	445,133,146
Expense provision		95,586,069
Payments		(10,232,736)
Balance at September 30, 2006	$	530,486,479

The amounts due within one year for the fiscal years ended September 30, 2006 and September 30, 2005 are $10,000,000 and $6,000,000, 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 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 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 employees 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 INTERNAL CONTROL AND COMPLIANCE

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

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

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

Mr. Robert J. Kleine, Chair
Board of Directors
and
Ms. Robin R. Lott, Executive Director
Michigan Education Trust
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine and Ms. Lott:

We have audited the statement of net assets (deficit); the statement of revenues, expenses, and changes in net assets (deficit); and the statement of cash flows of the Michigan Education Trust Plan D, a component unit of the State of Michigan, as of and for the fiscal years ended September 30, 2006 and September 30, 2005 and have issued our report thereon dated December 22, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Michigan Education 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 an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control 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 the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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 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*.

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

December 22, 2006

GLOSSARY

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 Service.
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 changes in financial position 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 initiate, record, process, 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.

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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL