



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT



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

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

– Article IV, Section 53 of the Michigan Constitution

Audit report information can be accessed at:

<http://audgen.michigan.gov>



Michigan
Office of the Auditor General
REPORT SUMMARY

Financial Audit

Report Number:
 071-0155-11

State of Michigan 457 Plan

October 1, 2008 through September 30, 2010

Released:
 May 2011

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 State of Michigan 457 Plan 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 State of Michigan 457 Plan's basic financial statements.

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Internal Control Over Financial Reporting

We identified a material weakness in internal control over financial reporting (Finding 1).

The Office of Retirement Services (ORS) and Financial Services' internal control over financial reporting did not ensure that it would prevent, or detect and correct, financial statement misstatements and misclassifications in a timely manner. As a result, we identified several financial statement errors during our audit that, when brought to Financial Services' attention, were corrected. (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 includes 1 finding and 1 corresponding recommendation. The Department of Technology, Management & Budget's preliminary response indicates that ORS and Financial Services agree with the recommendation.

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Background:

The State of Michigan 457 Plan is a deferred compensation fund sponsored by the State of Michigan. The Plan was established by the Civil Service Commission in 1974 as a means for all employees to build funds for retirement. All employees of the State are eligible to participate in the Plan on the first day of

employment and may voluntarily contribute a portion of their compensation up to the established Internal Revenue Code limits.

There is also a State of Michigan 401K Plan, which is a deferred compensation fund and a defined contribution retirement fund sponsored by the State of Michigan. State employees are eligible to participate in either or both of these plans. The State of Michigan 401K Plan annual financial report is issued separately.

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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



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

May 26, 2011

John E. Nixon, C.P.A., Director
Department of Technology, Management & Budget
George W. Romney Building
Lansing, Michigan
and
Mr. Phillip Stoddard, Director
Office of Retirement Services
Department of Technology, Management & Budget
General Office Building - Third Floor
Lansing, Michigan

Dear Mr. Nixon and Mr. Stoddard:

This is our report on the financial audit of the State of Michigan 457 Plan for the period October 1, 2008 through September 30, 2010.

This report contains our report summary, our independent auditor's report on the financial statements, the Plan management's discussion and analysis, and the Plan's financial statements. This report also contains our independent auditor's report on internal control over financial reporting and on compliance and other matters; 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 address the audit recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

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

AUDITOR GENERAL

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INDEPENDENT AUDITOR'S REPORT



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

Independent Auditor's Report on the Financial Statements

John E. Nixon, C.P.A., Director
Department of Technology, Management & Budget
George W. Romney Building
Lansing, Michigan
and
Mr. Phillip Stoddard, Director
Office of Retirement Services
Department of Technology, Management & Budget
General Office Building - Third Floor
Lansing, Michigan

Dear Mr. Nixon and Mr. Stoddard:

We have audited the accompanying financial statements of the State of Michigan 457 Plan as of and for the fiscal years ended September 30, 2010 and September 30, 2009, which collectively comprise the Plan's basic financial statements, as identified in the table of contents. These financial statements are the responsibility of the Plan'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 State of Michigan 457 Plan and do not purport to, and do not, present fairly the financial position of the State of Michigan or its pension (and other employee benefit) trust funds as of September 30, 2010 and September 30, 2009 and the changes in financial position 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 plan net assets of the State of Michigan 457 Plan as of September 30, 2010 and September 30, 2009 and the changes in plan net assets for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 6, the Plan adopted Governmental Accounting Standards Board Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 10, 2011 on our consideration of the Plan'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 on pages 11 through 14 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

May 10, 2011

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the State of Michigan 457 Plan's (the Plan) annual financial report presents our discussion and analysis of the Plan's financial performance and provides an overview of the Plan's financial activities for the fiscal years ended September 30, 2010 and September 30, 2009. Please read it in conjunction with the basic financial statements, which follow this discussion.

Using This Annual Financial Report

This annual financial report consists of two parts: (1) management's discussion and analysis (this section) and (2) the basic financial statements. The financial statements also include notes that explain some of the information in the financial statements and provide more detailed data.

Condensed Financial Information

The table below compares key financial information in a condensed format between the current year and the two prior years:

	Fiscal Year Ended September 30		
	2010	2009	2008
Trust Net Assets	<u>\$1,764,910,216</u>	<u>\$1,723,503,760</u>	<u>\$1,770,683,408</u>
Net investment gain (loss)	\$ 113,808,568	\$ 17,610,606	\$ (237,762,414)
Contributions - Employee	59,302,100	59,610,485	66,872,052
Contributions - From other systems	322,665	87,119	251,818
Benefits paid	(63,506,079)	(65,866,055)	(75,755,062)
Refunds and payments to other systems	(66,664,389)	(56,826,365)	(78,971,340)
Other income and expenses	(1,856,409)	(1,795,438)	(1,556,162)
Net Increase (Decrease) in Trust Net Assets	<u>\$ 41,406,456</u>	<u>\$ (47,179,648)</u>	<u>\$ (326,921,108)</u>

Overall Fund Structure and Objectives

The Plan was established by the Civil Service Commission in 1974 as a means for all employees to build funds for retirement. All employees of the State are eligible to participate in the Plan on the first day of employment and may voluntarily contribute a portion of their compensation up to the established Internal Revenue Code limits. Contributions are limited to those made by the participants and, as such, participants are 100 percent vested at all times.

Asset Allocation

All participants have the ability to direct the investments of their accounts under the Plan, in accordance with the investment choices as are made available and those policies or procedures as are determined by the trustee and the administration from time to time. The State has no control over investment decisions made by the participants. The Plan may be invested and reinvested in various instruments as deemed appropriate by trustee and Plan management. Several investment tiers have been developed and made available to participants. A summary of the types of investments is listed in Note 4.

Investment Results

Despite a poor showing in August, equity performance in July and September catapulted all broad U.S. market metrics back into positive territory for the quarter ended September 30, 2010 and the year to date. In general, the global economy has decelerated as the positive impact from inventory rebuilding has begun to wane and private demand has yet to fully ramp up. The third quarter was one of extremes for global equities, with two very strong months sandwiching a poor August. The S&P* 500 Index surged 11.3 percent in the third quarter, while the Dow Jones Industrial Average and the tech-heavy NASDAQ posted gains of 10.4 percent and 12.6 percent, respectively. All ten S&P 500 sectors generated positive returns for the quarter. In terms of market capitalization, mid caps were the top performers, trailed by small and large caps. Growth outperformed value across capitalizations. International equity markets were even more robust. The Morgan Stanley Capital International (MSCI) Emerging Markets Index continues to outpace the developed market indexes, finishing up 17.2 percent for the quarter.

Despite some recent positive economic indicators, continued high unemployment and low inflation suggest that a second round of quantitative easing is quite possible. Interest rates fell for much of the third quarter, as data released throughout the period suggested slowing economic growth. Given the myriad issues that face the global economy, however, investors should be careful to keep a close tactical eye on exposure to risk.

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

By the time fiscal year 2009-10 closed, the total fund posted a net investment gain of \$113.8 million or 6.6 percent of beginning net assets as compared to fiscal year 2008-09, which posted a net investment gain of \$17.6 million or 1.0 percent of beginning net assets.

For fiscal year 2008-09, while financial markets continued to experience significant challenges, the economy showed early signs of recovery. Although equity markets bottomed out in mid-March, they saw a strong recovery throughout the summer with the S&P 500 Index posting a third quarter return of more than 15.0 percent, one of the best quarters ever. Risk-based fixed income assets also posted gains for the period. While indicative of a stabilizing environment for most of the quarter, economic data grew mixed toward the end of September. Investors generally grew cautious in the last week of September, as disappointing economic data, depressed buying activity, and banner gains for the quarter left some uneasy about the prospects for a continued bullish environment. However, despite this late-period weakness, the final quarter of the fiscal year was extremely robust. The S&P 500 Index, the Dow Jones Industrial Average, and the NASDAQ composite were all up more than 15.0 percent. In fiscal year 2007-08, as a result of depressed equity markets, the S&P 500 lost 23.0 percent, while the international equity index, MSCI EAFE, was down 30.9 percent for the same period.

In fiscal year 2008-09, financials were the top-performing guaranteed investment contract (GIC) sector for the quarter by a large margin, while international markets - and emerging markets in particular - were also strong in the last quarter of the fiscal year. While rates dropped across the U.S. Treasury yield curve, 7-, 10-, and 30-year bonds performed best in a flattening environment. Risk-based fixed income assets posted a very strong quarter as positive excess returns continued unabated. By comparison, the bond market in fiscal year 2007-08 was up a modest 3.5 percent for the year measured by the Lehman Aggregate Index, and the Federal Reserve announced six interest rate cuts during the year.

By the time fiscal year 2008-09 closed, the total fund posted a net investment gain of \$17.6 million or 1.0 percent of beginning net assets as compared to fiscal year 2007-08, which posted a net investment loss of \$237.8 million or 11.3 percent of beginning net assets.

Contacting Management

This report is designed to provide the retirement boards, our membership, taxpayers, investors, and creditors with a general overview of the Plan's finances and to demonstrate the Plan's accountability for the money it receives. If you have any questions about this report or need additional information, contact the Office of Retirement Services, P.O. Box 30171, Lansing, MI 48909-7671.

BASIC FINANCIAL STATEMENTS

STATE OF MICHIGAN 457 PLAN
Statement of Plan Net Assets

	September 30	
	2010	2009 (Note 3)
Assets		
Equity in common cash	\$ 1,150,734	\$ 1,130,431
Participant-directed investments - At fair value/contract value (Note 4):		
Stable Value Fund	820,201,871	852,156,781
ING Small Cap Growth Equity Fund	37,371,704	
Mutual funds	451,453,804	464,735,049
Common trust funds	408,743,723	364,514,637
Tier III investments	45,745,573	40,810,921
Other receivable	242,807	155,940
	\$ 1,764,910,216	\$ 1,723,503,760
Plan Net Assets	\$ 1,764,910,216	\$ 1,723,503,760

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

STATE OF MICHIGAN 457 PLAN
Statement of Changes in Plan Net Assets

	Fiscal Year Ended September 30	
	2010	2009
Additions to Net Assets Attributed to		
Investment income (loss):		
Interest and dividends	\$ 25,106,417	\$ 43,704,081
Net appreciation (depreciation) in fair value of investments	88,702,151	(26,093,475)
Total investment income (loss)	<u>\$ 113,808,568</u>	<u>\$ 17,610,606</u>
Contributions:		
Employees	\$ 59,302,100	\$ 59,610,485
Transfers from other plans	64,160	239,710
From other systems	322,665	87,119
Total contributions	<u>\$ 59,688,925</u>	<u>\$ 59,937,314</u>
Miscellaneous income	<u>\$ 683,888</u>	<u>\$ 583,138</u>
Total additions (deductions)	<u>\$ 174,181,381</u>	<u>\$ 78,131,058</u>
Deductions from Net Assets Attributed to		
Benefits paid to participants (Note 3)	\$ 63,506,079	\$ 65,866,055
Administrative and investment expenses	2,604,457	2,618,286
Refunds and payments to other systems (Note 3)	66,664,389	56,826,365
Total deductions	<u>\$ 132,774,925</u>	<u>\$ 125,310,706</u>
Net Increase (Decrease)	<u>\$ 41,406,456</u>	<u>\$ (47,179,648)</u>
Plan Net Assets		
Beginning of fiscal year	<u>1,723,503,760</u>	<u>1,770,683,408</u>
End of fiscal year	<u>\$ 1,764,910,216</u>	<u>\$ 1,723,503,760</u>

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

Notes to the Financial Statements

Note 1 Summary of Significant Accounting Policies

The State of Michigan 457 Plan is a deferred compensation fund sponsored by the State of Michigan. The Plan covers employees of the State of Michigan. There is also a State of Michigan 401K Plan, which is a deferred compensation fund and a defined contribution retirement fund sponsored by the State of Michigan. State employees are eligible to participate in either or both of these plans. The State of Michigan 401K Plan annual financial report is issued separately.

Basis of Presentation - The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board. The accompanying financial statements present only the State of Michigan 457 Plan. Accordingly, they do not purport to, and do not, present fairly the financial position and the changes in financial position of the State of Michigan as a whole or its pension (and other employee benefit) trust funds in conformity with accounting principles generally accepted in the United States of America.

Measurement Focus and Basis of Accounting - The Plan uses the economic resources measurement focus and the accrual basis of accounting. Employee contributions are recognized in the period in which the contributions are due.

Investments - Investments in the ING Small Cap Growth Equity Fund, mutual funds, common trust funds, and Tier III investments are stated at fair value based on quoted market prices. Most of the Stable Value Fund is stated at contract value (see Note 4 for additional information). Investments in common trust funds are funds managed by State Street Global Advisors (SSgA) and Rainier Investment Management, similar to mutual funds, but they are not registered like mutual funds. Independent audits of the common trust funds as a whole are performed by other auditors. The funds do not report to the Securities and Exchange Commission (SEC) but are required to submit reports to the U.S. Department of Labor. The fair value of the Plan's position in the common cash fund is equivalent to the fair value of the common cash fund shares.

Note 2 General Description of the Plan

The following brief description of the Plan provides only general information. Participants should refer to the Plan Document for a more complete description of the Plan's provisions.

General - The Plan was established by the Civil Service Commission in 1974. The first enrollment was on April 17, 1975, with contributions starting in May 1975. The Plan was amended and restated effective January 1, 2008 to incorporate all amendments since the last restatement, update changes required by law, and add new sections for any changes in provisions made during the Plan year.

Eligibility - All employees of the State of Michigan are eligible to participate in the Plan on the first day of employment.

Contributions From Other Systems - Active employees may roll over money from another 457 Plan to their State of Michigan 457 Plan account. Participants may withdraw funds rolled into the Plan at any time.

Contributions - Employees may voluntarily elect to contribute a portion of their compensation to the Plan through payroll deductions. In accordance with the Internal Revenue Code (IRC), the Plan limits the amount of an individual's annual contribution. Certain participants may also be allowed to make "catch-up" contributions in accordance with the IRC. There are no required or discretionary employer contributions in accordance with the Plan Document.

Participant Account - Each participant's account is credited with his or her contributions and an allocation of the Plan's earnings. Allocations are based on the participant's account balance to reflect the effect of income or losses from the particular investments. The benefit to which a participant is entitled is the benefit that can be provided from the participant's account.

Vesting - Participants are 100 percent vested at all times.

Payment of Benefits - Participants may withdraw their funds upon leaving State service. Withdrawal of participant funds may be by lump sum, monthly payments, or annual payments. Payments may occur over a period not to exceed life expectancy from the date the payments begin. In-service benefit payments are permitted for various reasons as outlined in the Plan Document.

Refunds and Payments to Other Systems - Participants may rollover all or a portion of their account balance to other qualified plans upon leaving State service. Participants may also use all or a portion of their account balances to purchase pre-approved service credit in the State of Michigan's Defined Benefit Retirement Plan.

Note 3 Reclassification

Classifications of participant-directed investments for fiscal year 2008-09 on the statement of plan net assets have been reclassified to correct the classification error in investments. In addition, benefits paid to participants on the statement of changes in plan net assets for fiscal year 2008-09 have been reclassified to conform to fiscal year 2009-10 statement presentation for comparative purposes. The total activity for the Plan remained the same.

Note 4 Investments

All investments are participant directed. The mutual funds are registered with the SEC, and the bank investment contracts (BICs) and guaranteed investment contracts (GICs) are regulated. Several investment tiers have been developed and made available to participants. A brief summary of the types of investments included in each tier is listed below:

Tier I - Stable Value Fund, SSgA Yield Enhanced STIF, SSgA Bond Market Index Fund, S&P 500 Index Fund, S&P MidCap Index Fund, Russell 2000 Index Fund, Target Retirement Income Fund, and Target Retirement Funds ranging in retirement dates from 2010 through 2050.

Tier II - MFS Total Return Fund, Dodge & Cox Stock Fund, Oakmark Equity and Income Fund, Rainier Large Cap Growth Equity Fund, T. Rowe Price Mid Cap Value Fund, ING Small Cap Growth Equity Fund, Ridgeworth Small Cap Value Equity Fund, American Funds EuroPacific Growth Fund, Artisan Mid Cap Fund, PIMCO Total Return Fund, and SSgA Emerging Markets Fund.

Tier III - Individual stocks and bonds and thousands of mutual funds (load, no-load, and no-fee/no-load) from a multitude of fund families are available through the Plan's third party administrator. The various types of investments within Tier III are self-managed assets by the participants and are not separately classified by type of investment by the Plan's third party administrator. These self-managed stocks, bonds, and mutual funds are presented on the statement of plan net assets as Tier III investments.

The Plan's investments are subject to several types of risk. As of September 30, 2010 and September 30, 2009, the Plan did not have any investments subject to custodial credit risk or concentration of credit risk. Other types of risk are examined in more detail below:

a. Interest Rate Risk

Interest rate risk is the risk that the value of debt investments will decrease as a result of a rise in interest rates. The Plan's investment policy does not restrict investment maturities. At year-end, the average maturities of investments were as follows:

Investment Type	Fair Value/ Contract Value	Weighted Average Maturity (Years)
2010		
Stable Value Fund:		
Traditional GICs/BICs *	\$ 27,773,214	1.40
Synthetic contracts *	\$ 724,690,642	4.38
SSgA STIF	\$ 67,738,015	0.14
Common trust funds:		
SSgA Bond Market Index Fund	\$ 77,487,701	6.48
SSgA Yield Enhanced STIF	\$ 24,326,049	0.01
Mutual funds:		
PIMCO Total Return Fund	\$ 42,691,903	7.12
MFS Total Return Fund	\$ 18,094,667	5.99
2009		
Stable Value Fund:		
Traditional GICs/BICs *	\$ 39,653,222	1.11
Buy and hold synthetics *	\$ 2,866,624	0.46
Global wrap synthetic contracts *	\$ 747,846,666	2.94
SSgA STIF	\$ 61,790,269	0.14
Common trust funds:		
SSgA Bond Market Index Fund	\$ 60,943,986	6.46
SSgA Yield Enhanced STIF	\$ 26,155,027	0.14
Mutual funds:		
PIMCO Total Return Fund	\$ 26,873,714	6.46
MFS Total Return Fund	\$ 18,430,307	6.30

* These investments are reported at contract value as disclosed in Note 1.

b. Credit Risk

The Plan has an investment policy that limits its investment choices. The investment choices offered to participants are defined by tiers as described in the preceding paragraphs. As of year-end, the credit quality ratings of debt securities (other than U.S. government securities) were as follows:

Investment Type	Fair Value/ Contract Value	Rating	Rating Organization
2010			
Stable Value Fund:			
Traditional GICs/BICs *	\$ 27,773,214	A to AAA	S&P
Synthetic contracts *	\$ 724,690,642	A to AAA	S&P
SSgA STIF	\$ 67,738,015	A1/P1 to Aaa	Moody's*
Common trust funds:			
SSgA Bond Market Index Fund	\$ 77,487,701	Baa to Aaa	Moody's
SSgA Yield Enhanced STIF	\$ 24,326,049	NR to Aaa	Moody's
Mutual funds:			
PIMCO Total Return Fund	\$ 42,691,903	Below B to AAA	S&P
MFS Total Return Fund	\$ 18,094,667	NR to AAA	S&P
2009			
Stable Value Fund:			
Traditional GICs/BICs *	\$ 39,653,222	NR to AA-	S&P
Buy and hold synthetics *	\$ 2,866,624	AA	S&P
Global wrap synthetic contracts *	\$ 747,846,666	AA- to A+	S&P
SSgA STIF	\$ 61,790,269	P-1	Moody's
Common trust funds:			
SSgA Bond Market Index Fund	\$ 60,943,986	Baa to Aaa	Moody's
SSgA Yield Enhanced STIF	\$ 26,155,027	NR to Aaa	Moody's
Mutual funds:			
PIMCO Total Return Fund	\$ 26,873,714	Below B to AAA	S&P
MFS Total Return Fund	\$ 18,430,307	NR to AAA	S&P

* These investments are reported at contract value as disclosed in Note 1.

* See glossary at end of report for definition.

c. Foreign Currency Risk

Foreign currency risk is the risk that changes in foreign currency rates will adversely affect the fair value of an investment. As of year-end, the foreign currency risk of securities (other than U.S. government securities) was as follows:

Investment Type	Foreign Currency	Fair Value
2010		
Mutual funds:		
American Funds EuroPacific Growth Fund	Various	\$120,097,969
SSgA Emerging Markets Fund	Various	\$ 74,820,488
PIMCO Total Return Fund	Various	\$ 42,691,903
SSgA Bond Market Index Fund	Various	\$ 77,487,701
2009		
Mutual funds:		
American Funds EuroPacific Growth Fund	Various	\$105,677,450
AllianceBernstein International Value Fund	Various	\$ 10,617,246
SSgA Emerging Markets Fund	Various	\$ 71,206,744
PIMCO Total Return Fund	Various	\$ 26,873,714
SSgA Bond Market Index Fund	Various	\$ 60,943,986

Fully Benefit Responsive Synthetic Guaranteed Investment Contract (SGIC):

As part of the Stable Value Fund, the Plan uses SGIC investment derivatives that invest in a portfolio of underlying securities and a Benefit Response Wrapper Contract(s). The Wrapper contract produces a floating rate of return that is adjusted periodically, but not below zero, to reflect the underlying investment portfolio and generally provides for participant withdrawals at contract value (principal plus accrued interest). Following are the fair values as of September 30, 2010 and September 30, 2009:

	Fair Value at September 30	
	2010	2009
SGIC Components:		
Underlying investments	\$752,654,027	\$860,366,404
Wrap contract		
Total	\$752,654,027	\$860,366,404

Note 5 Tax Status

The U.S. Department of Treasury made a determination on July 16, 1975 that the Plan constitutes a qualified trust under Section 401(a) of the Internal Revenue Code and is, therefore, exempt from federal income tax.

The Plan has been amended subsequent to the above date. Management believes that the Plan continues to operate as a qualified trust.

Note 6 Accounting Change

During fiscal year 2009-10, the Plan implemented Governmental Accounting Standards Board* (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. This Statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments. Note 4 includes disclosure regarding fully benefit responsive SGICs held as investments by the Plan. No other types of derivative instruments were held by the Plan during fiscal years 2009-10 and 2008-09.

* See glossary at end of report for definition.

INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND COMPLIANCE



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

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Department of Technology, Management & Budget
George W. Romney Building
Lansing, Michigan
and
Mr. Phillip Stoddard, Director
Office of Retirement Services
Department of Technology, Management & Budget
General Office Building - Third Floor
Lansing, Michigan

Dear Mr. Nixon and Mr. Stoddard:

We have audited the financial statements of the State of Michigan 457 Plan as of and for the fiscal years ended September 30, 2010 and September 30, 2009, which collectively comprise the Plan's basic financial statements as identified in the table of contents, and have issued our report thereon dated May 10, 2011. 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 Plan's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Plan's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in Finding 1, we identified a deficiency in internal control over financial reporting that we consider to be a material weakness.

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. We consider the deficiency described in Finding 1 to be a material weakness.

Compliance and Other Matters

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

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

This report is intended solely for the information and use of the Governor, the Legislature, the State of Michigan 457 Plan management, and others within the Department of Technology, Management & Budget and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL

May 10, 2011

FINDING, RECOMMENDATION,
AND AGENCY PRELIMINARY RESPONSE

FINDING

1. **Controls Over the Financial Activity Provided by the Third Party Administrator**

The Office of Retirement Services (ORS) and Financial Services' internal control over financial reporting did not ensure that it would prevent, or detect and correct, financial statement misstatements and misclassifications in a timely manner. As a result, we identified several financial statement errors during our audit that, when brought to Financial Services' attention, were corrected.

ORS contracts with a third party administrator (TPA) to provide recordkeeping, administration, custodial, and education services for the State of Michigan 457 Plan. ORS also has a business partnership agreement with Financial Services to provide accounting services to record the summary financial transactions and prepare the financial statements for the Plan. The TPA contracts directly with a custodian for services that include safekeeping of assets, portfolio accounting, and pricing of securities. The TPA and custodian reconcile their records daily and provide Financial Services with monthly activity reports for the Plan.

Financial Services obtains the Plan's financial activity from the TPA and custodian in order to monitor the activity of the Plan and prepare the Plan's financial statements. We identified the following reporting weaknesses:

- a. Financial Services did not use the correct methodology to classify investments on the Plan's statement of net assets available for plan benefits. As a result of our audit procedures and as confirmed by the TPA, Financial Services revised its methodology and correctly classified the investments for fiscal year 2009-10. However, for fiscal year 2008-09, Financial Services had to restate the classification of the Plan's investments because of the following:
 - Overstatement of the money market investments by \$88.5 million.
 - Overstatement of the mutual fund investments by \$99.6 million.
 - Overstatement of the common trust fund investments by \$704.8 million.
 - Understatement of the Stable Value Fund investments by \$852.2 million.
 - Understatement of the Tier III investments by \$40.8 million.

- b. Financial Services did not ensure that the financial activity provided by the custodian was complete and accurate, resulting in the following financial statement errors for fiscal year 2009-10:
- Understatement of interest and dividend income by \$4.6 million.
 - Overstatement of administrative and investment expenses by \$0.7 million.
 - Overstatement of net appreciation (depreciation) in fair value of investments by \$3.9 million.
- c. ORS and Financial Services did not require the TPA to identify adjustments and activity that should have been excluded from the financial statements. For example, we identified a \$0.9 million inter-Plan adjustment to one participant's account that was incorrectly reflected as a contribution and a benefit payment in the financial statements when it was not a contribution or an adjustment. Financial Services corrected the error by reducing contributions and benefit payments each by \$0.9 million.

RECOMMENDATION

We recommend that ORS and Financial Services improve their internal control over financial reporting to ensure that it will prevent, or detect and correct, financial statement misstatements and misclassifications in a timely manner.

AGENCY PRELIMINARY RESPONSE

The Department of Technology, Management & Budget's ORS and Financial Services agree with the recommendation, but note that the initial misclassifications in the draft financial statements were corrected in the State's accounting record and that the published financial statements are accurate. In addition, ORS and Financial Services indicated that the participant accounts are accurately stated with the TPA. ORS and Financial Services informed us that the 457 Plan statement preparation processes and procedures are being reviewed and modified as necessary to improve existing internal control for determining the proper recording and reporting of financial information for the Plan. ORS and Financial Services indicated that meetings between the TPA, ORS, and Financial Services to define the reporting and data requirements of the Plan began in March 2011. ORS and Financial Services informed us that new monthly reports will be tested by June 2011 and that any other process improvements are expected to be implemented by August 2011.

GLOSSARY

Glossary of Acronyms and Terms

BICs	bank investment contracts.
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.
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 presented fairly in all material respects in conformity with the disclosed basis of accounting.
GICs	guaranteed investment contracts.
Governmental Accounting Standards Board (GASB)	An arm of the Financial Accounting Foundation established to promulgate standards of financial accounting and reporting with respect to activities and transactions of state and local governmental entities.
internal control	A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
material misstatement	A misstatement in the 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 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 schedules and/or financial statements will not be prevented, or detected and corrected, on a timely basis.
MFS	MFS Investment Management.
Moody's	Moody's Investors Service, Inc. A credit rating agency that, among other things, provides credit ratings for issuers of certain debt obligations or debt instruments.
ORS	Office of Retirement Services.
PIMCO	Pacific Investment Management Company, LLC.
S&P	Standard & Poor's. A credit rating agency that, among other things, provides credit ratings for issuers of certain debt obligations or debt instruments.
SEC	Securities and Exchange Commission.
SGIC	synthetic guaranteed investment contract.
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.
SSgA	State Street Global Advisors.
STIF	short-term investment fund.
TPA	third party administrator.

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.

