MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

FINANCIAL AUDIT
OF THE

STATE OF MICHIGAN 401K PLAN

October 1, 2008 through September 30, 2010

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

071-0156-11

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:
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Michigan

Office of the Auditor General

REPORT SUMMARY

Financial Audit

State of Michigan 401K Plan

October 1, 2008 through September 30, 2010

Report Number:
071-0156-11

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

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

There is also a State of Michigan 457 Plan, which is a deferred compensation fund sponsored by the State of Michigan. State employees are eligible to participate in either or both of these plans. The State of Michigan 457 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

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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 401K 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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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 401K 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 401K 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 401K 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 3, the Plan restated beginning net assets for fiscal year 2009-10 for the defined contribution retirement fund and the 401k deferred compensation fund of the Plan by $343,307,748 due to errors in prior fiscal years.

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 9, 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 9, 2011

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the State of Michigan 401K 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	$3,064,806,119	$2,750,169,790	$2,631,308,442
Net investment gain (loss)	$ 236,684,112	$ 34,916,337	$ (492,538,657)
Contributions - Employer	95,913,133	89,882,688	81,595,032
Contributions - Employee	154,933,900	147,398,721	157,725,139
Contributions - From other systems	5,232,620	2,490,231	3,721,760
Benefits paid	(84,140,622)	(80,994,650)	(51,684,436)
Refunds and payments to other systems	(91,468,066)	(68,105,544)	(95,294,501)
Other income and expenses	(2,518,751)	(6,726,435)	(7,408,505)
Net Increase (Decrease) in Trust Net Assets	$ 314,636,328	$ 118,861,348	$ (403,884,168)

Overall Fund Structure and Objectives

The Plan was established by the Civil Service Commission in 1985 as a 401k plan and amended in March 1997 to implement a defined contribution component as a means for all employees to build funds for retirement. All employees of the State become 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.

The Plan provides for the State of Michigan to make a mandatory contribution of 4.0 percent of each participant's compensation for employees not covered by the State's defined benefit plans. Participants are 100 percent vested in their salary deferrals at all times and vest in the employer contributions based on years of service. The Plan is more fully described in Note 2.

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 the 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 and were 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

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

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.

By the time fiscal year 2009-10 closed, the total fund posted a net investment gain of $236.7 million or 8.6 percent of beginning net assets as compared to fiscal year 2008-09, which posted a net investment gain of $34.9 million or 1.3 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 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 $34.9 million or 1.3 percent of beginning net assets as compared to fiscal year 2007-08, which posted a net investment loss of $492.5 million or 16.1 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 401K PLAN
Statement of Plan Net Assets

	September 30, 2010			September 30, 2009
	Defined Contribution Retirement Fund	401k Deferred Compensation Fund	Total	Total (Note 3)
Assets				
Equity in common cash	$ 120,803	$ 863,096	$ 983,899	$ 1,019,158
Participant-directed investments, at fair value/contract value (Note 4):				
Stable Value Fund	123,850,568	379,869,092	503,719,660	493,592,256
ING Small Cap Growth Equity Fund	54,367,946	47,964,560	102,332,506	
Mutual funds	465,481,224	549,275,268	1,014,756,492	997,613,444
Common trust funds	650,006,665	477,531,544	1,127,538,209	961,156,093
Tier III investments	54,173,205	43,611,973	97,785,179	88,592,676
Participant loans	133,035,487	84,275,799	217,311,286	207,949,264
Other receivable	128,309	250,578	378,887	246,898
Plan Net Assets	$ 1,481,164,208	$ 1,583,641,911	$ 3,064,806,119	$ 2,750,169,790

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

STATE OF MICHIGAN 401K PLAN
Statement of Changes in Plan Net Assets

	Fiscal Year Ended September 30			
	2010			2009
	Defined Contribution Retirement Fund	401k Deferred Compensation Fund	Total	Total
Additions to Net Assets				
Investment income (loss):				
Interest and dividends	$ 29,122,303	$ 4,673,200	$ 33,795,503	$ 47,458,635
Net appreciation (depreciation) in fair value of investments	94,048,786	108,839,823	202,888,609	(12,542,298)
Total investment income (loss)	$ 123,171,089	$ 113,513,023	$ 236,684,112	$ 34,916,337
Contributions:				
Employees	$ 70,998,266	$ 83,935,634	$ 154,933,900	$ 147,398,721
Employer	95,913,133		95,913,133	89,882,688
Transfers from other plans	17,482	5,114,482	5,131,964	914,136
From other systems	3,080,765	2,151,855	5,232,620	2,490,231
Total contributions	$ 170,009,647	$ 91,201,971	$ 261,211,618	$ 240,685,776
Miscellaneous income	$ 495,272	$ 548,003	$ 1,043,276	$ 869,038
Total additions (deductions)	$ 293,676,009	$ 205,262,997	$ 498,939,006	$ 276,471,151
Deductions from Net Assets				
Benefits paid to participants (Note 3)	$ 42,830,530	$ 41,310,092	$ 84,140,622	$ 80,994,650
Administrative and investment expenses	3,873,995	3,307,567	7,181,563	5,956,104
Transfers to other plans		1,512,428	1,512,428	2,553,505
Refunds and payments to other systems (Note 3)	33,507,486	57,960,580	91,468,066	68,105,544
Total deductions	$ 80,212,011	$ 104,090,667	$ 184,302,678	$ 157,609,803
Net Increase (Decrease)	$ 213,463,999	$ 101,172,330	$ 314,636,328	$ 118,861,348
Plan Net Assets				
Beginning of fiscal year - restated (Note 3)	1,267,700,209	1,482,469,582	2,750,169,790	2,631,308,442
End of fiscal year	$ 1,481,164,208	$ 1,583,641,911	$ 3,064,806,119	$ 2,750,169,790

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

Note 1 Summary of Significant Accounting Policies

The State of Michigan 401K Plan is a deferred compensation fund and a defined contribution retirement fund sponsored by the State of Michigan. The Plan covers employees of the State of Michigan. There is also a State of Michigan 457 Plan, which is a deferred compensation fund sponsored by the State of Michigan. State employees are eligible to participate in either or both of these plans. The State of Michigan 457 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 401K 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. Employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions.

Investments - Investments in the ING Small Cap Growth Equity Fund, mutual funds, common trust funds, and Tier III investments are stated at fair value as determined by quoted market prices. Most of the Stable Value Fund is stated at contract value (see Note 4 for additional information). Participant loans are stated at face value, which approximates market value. Investments in common trust funds are funds managed by State Street Global Advisors (SSgA) and Rainier Investment Management, similar to mutual funds, but 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 1985 as a deferred compensation 401k plan. The Plan was amended as of March 31, 1997 to implement a defined contribution retirement component. 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. As of September 30, 2010, there were 34,389 participants in the Plan.

Eligibility - All employees become eligible to participate on the first day of employment in the deferred compensation 401k component of the Plan. Employees hired on or after March 31, 1997 become eligible on the first day of employment for the defined contribution retirement component of the Plan. Employees hired prior to March 31, 1997 could also become eligible for the defined contribution retirement component if they irrevocably elected to forgo participation in a defined benefit pension plan sponsored by the State of Michigan and to become a participant in the Plan.

Contributions - In accordance with Section 401k of the Internal Revenue Code, effective January 1, 1987, the Plan limits the amount of an individual's annual contribution.

The Plan provides for the State of Michigan to make a mandatory contribution of 4.0 percent of each participant's compensation for employees in the defined contribution retirement component of the Plan and not covered by the State's defined benefit pension plans. The State is also required to make matching contributions equal to elective deferrals to the Plan, up to a maximum of 3.0 percent of each participant's compensation for employees in the defined contribution retirement component of the Plan. The State does not make matching contributions for employees in the deferred compensation 401k component of the Plan.

Contributions From Other Systems - Active employees may rollover money from another 401k plan, 401a or 403b plans, or from traditional individual retirement accounts (IRAs) into their account in the State of Michigan 401K Plan. Participants may withdraw funds rolled into the Plan at any time.

Participant Account - Each participant's account is credited with his or her contributions; the State's contributions, if applicable; 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 of the Plan are 100 percent vested in their salary deferrals at all times. Participants in the defined contribution retirement component of the Plan are vested in employer contributions based on years of service over a four-year period. A participant is 100 percent vested after four years of service credit. A year of service is defined as 2,080 hours.

Loans to Participants - Participants may borrow from their vested account balances of the Plan in accordance with the loan policy statement. Loan amounts can range from a minimum of $1,000 to a maximum of $50,000. Loans must be repaid within five years, with the exception of real estate loans, which may be extended beyond five years. The interest rate on loans reflects a rate equal to the prime interest rate on the first day of the prior month.

Loans to Participants - Defaulted - Defaulted loans are loans resulting from the failure of a participant to make the required loan repayments on an outstanding loan and are considered deemed distributed loans. These loans are considered a distribution to the participant for which a federal 1099 tax form is issued. If a loan is issued after January 1, 2002 and the participant is still active and the loan has been defaulted on, it is categorized as a deemed distributed loan. The fund remains intact and remains as an outstanding loan for purposes of number of loans allowed and is used in the loan availability calculation. Participants do have the option to repay a deemed distributed loan. Fiscal year 2009-10 deemed distributed loans totaled $7,190,037 for defined contribution participants and $5,130,462 for 401k deferred compensation participants at September 30, 2010.

Payment of Benefits - Participants may withdraw their funds upon leaving State service. Withdrawal of participant funds may be by lump sum, monthly payments, annual payments, or rollovers to other qualified plans. 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 funds to other qualified plans upon leaving State service. Participants in the 401k deferred compensation component 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.

In fiscal year 2009-10, $7,158,658 of employer contributions was refunded to the State of Michigan's Defined Benefit Retirement Plan to refund the employer contributions previously made by the State for participants that were incorrectly placed in the defined contribution retirement component of the Plan. In fiscal year 2009-10, these participants were moved to the 401k deferred compensation component of the Plan.

Forfeited Accounts - Forfeited nonvested accounts totaled $9,548,729 and $8,048,585 at September 30, 2010 and September 30, 2009, respectively. Internal Revenue Code section 401(a)(2) restricts the State from recapturing any contributions made to the Plan. Accordingly, as specified in the Plan Document, the funds in the forfeited accounts are used to offset future State contributions and to pay administrative expenses of the Plan.

Other Postemployment Benefits (OPEB) - OPEB for defined contribution retirement plan members are currently included in the actuarial valuation provided by the various retirement systems and reported in the retirement systems' financial statements. For more information regarding these benefits, please refer to the separately issued retirement systems' comprehensive annual financial reports.

Note 3 **Restatement and Reclassification**

During fiscal year 2009-10, it was noted that activity for both the defined contribution retirement fund and the 401k deferred compensation fund was incorrectly reflected in the Plan. As a result, beginning net assets for fiscal year 2009-10 have been restated to increase investments by $1,267,700,209 for the defined contribution retirement fund and to decrease investments by $1,482,469,582 for the 401k deferred compensation fund to correct this classification error. This resulted in a change of $343,307,748 in net assets between the two funds, but there was no effect on the Plan as a whole.

For the fiscal year ended September 30, 2010, benefit payments increased and participant loans decreased to reflect defaulted loans that the Plan has recorded as deemed distributed loans in the amount of $1,727,625 for defined contribution participants and $2,228,414 for 401k participants for the periods prior to fiscal year 2009-10 to account for the cumulative effect of an accounting error. The total amount of $3,956,039 was not considered material and thus did not require a restatement of the fiscal year 2008-09 financial statements.

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 within the 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 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 *	$ 17,056,671	1.40
Synthetic contracts *	$ 445,062,291	4.38
SSgA STIF	$ 41,600,698	0.14
Common trust funds:		
SSgA Bond Market Index Fund	$ 174,133,741	6.48
SSgA Yield Enhanced STIF	$ 191,485,087	0.01
Mutual funds:		
PIMCO Total Return Fund	$ 87,739,460	7.12
MFS Total Return Fund	$ 63,951,317	5.99
2009		
Stable Value Fund:		
Traditional GICs/BICs *	$ 22,740,863	1.14
Buy and hold synthetics *	$ 1,822,119	0.42
Global wrap synthetic contracts *	$ 420,242,947	2.73
SSgA STIF	$ 48,786,327	0.14
Common trust funds:		
SSgA Bond Market Index Fund	$ 135,254,842	6.46
SSgA Yield Enhanced STIF	$ 190,197,643	0.14
Mutual funds:		
PIMCO Total Return Fund	$ 59,332,516	6.46
MFS Total Return Fund	$ 60,746,224	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) were as follows:

Investment Type		Fair Value/ Contract Value	Rating	Rating Organization
2010				
Stable Value Fund:				
Traditional GICs/BICs *	$	17,056,671	A to AAA	S&P
Synthetic contracts *	$	445,062,291	A to AAA	S&P
SSgA STIF	$	41,600,698	A1/P1 to Aaa	Moody's*
Common trust funds				
SSgA Bond Market Index Fund	$	174,133,741	Baa to Aaa	Moody's
SSgA Yield Enhanced STIF	$	191,485,087	NR to Aaa	Moody's
Mutual funds:				
PIMCO Total Return Fund	$	87,739,460	Below B to AAA	S&P
MFS Total Return Fund	$	63,951,317	NR to AAA	S&P
2009				
Stable Value Fund:				
Traditional GICs/BICs *	$	22,740,863	NR to AA-	S&P
Buy and hold synthetics *	$	1,822,119	AA	S&P
Global wrap synthetic contracts *	$	420,242,947	AA- to A+	S&P
SSgA STIF	$	48,786,327	P-1	Moody's
Common trust funds:				
SSgA Bond Market Index Fund	$	135,254,842	Baa to Aaa	Moody's
SSgA Yield Enhanced STIF	$	190,197,643	NR to Aaa	Moody's
Mutual funds:				
PIMCO Total Return Fund	$	59,332,516	Below B to AAA	S&P
MFS Total Return Fund	$	60,746,224	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	$ 229,346,035
SSgA Emerging Markets Fund	Various	$ 163,446,263
PIMCO Total Return Fund	Various	$ 87,739,460
SSgA Bond Market Index Fund	Various	$ 174,133,741
2009		
Mutual funds:		
American Funds EuroPacific Growth Fund	Various	$ 165,479,294
AllianceBernstein International Value Fund	Various	$ 37,539,372
SSgA Emerging Markets Fund	Various	$ 145,184,605
PIMCO Total Return Fund	Various	$ 59,332,516
SSgA Bond Market Index Fund	Various	$ 135,254,842

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 values as of September 30, 2010 and September 30, 2009:

	Fair Value at September 30	
	2010	2009
SGIC Components:		
Underlying investments	$462,235,755	$498,336,009
Wrap contract		
Total	$462,235,755	$498,336,009

Note 5 Tax Status

The U.S. Department of Treasury made a determination in March 1986 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 and restated 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

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 Internal Control Over Financial Reporting and on Compliance and Other Matters

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 financial statements of the State of Michigan 401K 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 dated May 9, 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 401K 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 9, 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 401K 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 which include safekeeping of assets, managing individual member accounts, 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. In preparing the financial statements, Financial Services did not use the correct methodology to record contributions, benefit payments, and investment activity between the defined contribution retirement fund and 401k deferred compensation fund. As a result of our audit procedures and based on additional information provided by its TPA, Financial Services revised its financial statements and recorded the activity in the correct fund for fiscal year 2009-10. However, to correct the prior years' funds, Financial Services had to restate beginning net assets by increasing net assets for the defined contribution retirement fund and decreasing net assets for the 401k deferred compensation fund by $343.3 million.

   In addition, when the TPA provided the additional allocation information for fiscal year 2009-10, there was a difference in the TPA's records between the beginning net assets for the defined contribution retirement fund and the 401k deferred compensation fund of $12.8 million. The TPA explained that this could have been due to activity posted to the Plan after October 1, 2009. Financial Services recorded this difference as an increase in interest and dividend income for the defined contribution retirement fund and a decrease in interest and dividend income for the 401k deferred compensation fund rather than identifying and recording the actual activity making up this difference.

b. Financial Services did not properly classify investments on the Plan's statement of net assets available for plan benefits. As a result of our audit procedures and from confirmation with the TPA, Financial Services revised its classification of 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 due to the following:

- Overstatement of the money market investments by $239.5 million.
- Overstatement of the mutual fund investments by $228.6 million.
- Overstatement of the common trust fund investments by $114.1 million.
- Understatement of the Stable Value Fund investments by $493.6 million.
- Understatement of the Tier III investments by $88.6 million.

c. 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:

- Overstatement of interest and dividend income by $4.6 million.
- Understatement of administrative and investment expenses by $0.7 million.
- Understatement of net appreciation (depreciation) in fair value of investments by $3.9 million.

In addition, Financial Services did not classify participant loan interest reported by the TPA and custodian as interest income on the fund financial statements. As a result, interest income is understated and net appreciation in fair value of investments is overstated by $10.2 million in fiscal year 2009-10.

d. ORS and Financial Services did not require the TPA to clearly identify all financial activity to determine what should be included and excluded on the financial statements. For example, we identified the following weaknesses:

- During fiscal year 2009-10, ORS and Financial Services identified defined contribution participants that should be 401k participants. These participants were reclassified as 401k participants; however, the TPA did not report the $7.6 million employee contributions related to this reclassification for inclusion in the financial statements. In addition, the employer contributions of $5.0 million related to this reclassification were refunded to the State for the Defined Benefit Plan and were included in the refunds and payments to other systems. Financial Services also included this in the transfers from other systems line item, resulting in an overstatement of transfers from other systems of $5.0 million.

- The TPA did not clearly identify the interfund adjustments and activity that did not have a financial statement impact in order to exclude this activity from the financial statements. As a result, Financial Services did not exclude this activity and benefit payments were overstated by approximately $5.0 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 records 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 401K 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

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 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.
OPEB	other postemployment benefits.
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.

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