MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

FINANCIAL AUDIT
OF THE

STATE OF MICHIGAN 457 PLAN

October 1, 2009 through September 30, 2011

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

071-0155-12

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 457 Plan

October 1, 2009 through September 30, 2011

Report Number:
071-0155-12

Released:
June 2012

A financial audit determines if the financial statements are fairly presented; considers internal control over financial reporting; and determines compliance with requirements material to the financial statements. This financial audit of the 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 did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, we did identify a significant deficiency (Finding 1).

The Office of Retirement Services 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, contributions and benefit payments were understated by $7.4 million during fiscal year 2010-11 (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, and Budget's preliminary response indicates that it agrees 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. The Plan was amended by Act 75, P.A. 2010, to include qualifying members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010 as participants in the Plan.

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. Employer contributions for qualifying members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010 are reported in the 401K Plan. 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

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

June 5, 2012

John E. Nixon, C.P.A., Director
Department of Technology, Management, and Budget
George W. Romney Building
and
Mr. Phillip J. Stoddard, Director
Office of Retirement Services
Department of Technology, Management, and Budget
General Office Building
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, 2009 through September 30, 2011.

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 basic financial statements. This report also contains our independent auditor's report on internal control over financial reporting and on compliance and other matters; our finding, recommendation, and agency preliminary response; and a glossary of acronyms and terms.

The agency preliminary response was taken from the agency's response subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a plan to comply with the audit recommendation and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

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

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

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TABLE OF CONTENTS

STATE OF MICHIGAN 457 PLAN

FINDING, RECOMMENDATION, AND
AGENCY PRELIMINARY RESPONSE

GLOSSARY

INDEPENDENT AUDITOR'S REPORT

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

Independent Auditor's Report on
the Financial Statements

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

Dear Mr. Nixon and Mr. Stoddard:

We have audited the accompanying basic financial statements of the State of Michigan 457 Plan as of and for the fiscal years ended September 30, 2011 and September 30, 2010, 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, 2011 and September 30, 2010 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, 2011 and September 30, 2010 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 5, during fiscal year 2009-10, 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 11, 2012 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.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General
May 11, 2012

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, 2011 and September 30, 2010. 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		
	2011	2010	2009
Plan Net Assets	$1,587,296,984	$1,764,910,216	$1,723,503,760
Net investment gain (loss)	$ 81,952	$ 113,808,568	$ 17,610,606
Contributions - Employees	49,169,638	59,302,100	59,610,485
Contributions - From other systems	254,019	322,665	87,119
Benefits paid	(87,803,975)	(63,506,079)	(65,866,055)
Refunds and payments to other systems	(136,221,867)	(66,664,389)	(56,826,365)
Other income and expenses	(3,093,000)	(1,856,409)	(1,795,438)
Net Increase (Decrease) in Plan Net Assets	$ (177,613,232)	$ 41,406,456	$ (47,179,648)

During fiscal year 2010-11, Act 185, P.A. 2010, provided for an incentivized retirement program for State employees. Approximately 4,750 State employees retired under this program. As a result, employee contributions decreased and benefits paid and refunds and payments to other systems increased in the 457 Plan in fiscal year 2010-11.

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.

The Plan was amended in fiscal year 2009-10 to expand the definition of employer to include public school reporting units and participants to include qualifying members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010. These participants are pension plus members and their employee contributions and related activity are accounted for in the Plan as outlined in the Plan Document. The employer contributions for these members are accounted for in the State of Michigan 401K Plan. Activity for the State of Michigan employees remains unchanged.

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 Plan 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 3.

Investment Results

In late July 2011, the U.S. Congress reached an agreement to raise the debt ceiling. Although the agreement averted the worst possible outcome - a U.S. government default - it played a role in the downgrade of the U.S. sovereign debt rating that followed soon afterward. On August 5, Standard & Poor's (S&P) lowered its rating on U.S. debt to AA+ from AAA. The downgrade inspired market volatility of historic proportions; beginning on the first trading day following S&P's announcement, the Dow Jones Industrial Average closed more than 400 points from where it opened for four consecutive days, the longest such streak in the index's 115 years.

Although the Federal Reserve quickly responded, announcing after its August 9 meeting that it would keep the federal funds rate near zero through at least 2013, recent economic data has done little to inspire confidence.

Third calendar quarter equity markets were marked by extreme volatility and steep losses. The S&P 500 Index declined 13.9 percent, its worst quarterly performance since 2008, and the Dow Jones Industrial Average and tech-heavy NASDAQ lost 11.4 percent and 12.9 percent, respectively. Large cap outperformed mid and small caps during the quarter.

Despite the S&P downgrade, skittish investors looked to U.S. Treasury bills for refuge. As a result, U.S. Treasury bills as a whole were up 6.5 percent and long bonds gained 25 percent. Though they lagged the performance of the U.S. Treasury-heavy aggregate index, most domestic bond market sectors were positive, with the notable exception of high-yield bonds. Yields on money market instruments - such as U.S. Treasury bills, short-term agency securities, and high-quality commercial paper - remained very low throughout the third calendar quarter as the federal funds target rate traded within the 0.00 - 0.25 percent range. Rates are expected to remain low across the yield curve, economic growth is expected to remain tepid, and periods of heightened volatility are expected to become more frequent.

By the time fiscal year 2010-11 closed, the total fund posted a net investment gain of $81,952 or less than 1 percent of beginning net assets as compared to fiscal year 2009-10, which posted a net investment gain of $113.8 million or 6.6 percent of beginning net assets.

In fiscal year 2009-10, despite a poor showing in August, equity performance in July and September catapulted in all broad U.S. market metrics back into positive territory for the quarter ended September 30, 2010 and the year to date. 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.

Contacting Management

This report is designed to provide the retirement boards, Plan members, 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

	State of Michigan Deferred Compensation Plan	Public School Deferred Compensation Fund	September 30 2011	September 30 2010
Assets				
Equity in common cash	$ 1,435,789	$ 508,202	$ 1,943,991	$ 1,150,734
Participant-directed investments - At fair value/contract value (Note 3):				
Stable Value Fund	741,005,071	722	741,005,793	820,201,871
ING Small Cap Growth Equity Fund	30,170,363	3,061	30,173,424	37,371,704
Mutual funds	363,240,484	26,303	363,266,787	451,453,804
Common trust funds	407,858,529	2,691,687	410,550,216	408,743,723
Tier III investments	40,139,654		40,139,654	45,745,573
Other receivable	277,578	1,071	278,649	242,807
Total assets	$ 1,584,127,467	$ 3,231,046	$ 1,587,358,513	$ 1,764,910,216
Liabilities				
Accounts payable	$	$ 61,529	$ 61,529	$
Total liabilities	$ 0	$ 61,529	$ 61,529	$ 0
Plan Net Assets	$ 1,584,127,467	$ 3,169,517	$ 1,587,296,984	$ 1,764,910,216

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

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

	State of Michigan Deferred Compensation Plan	Public School Deferred Compensation Fund	Fiscal Year Ended September 30 2011	Fiscal Year Ended September 30 2010
Additions to Net Assets Attributed to				
Investment income (loss):				
Interest and dividends	$ 29,523,885	$ 20,478	$ 29,544,363	$ 25,106,417
Net appreciation (depreciation) in fair value of investments	(29,182,856)	(279,555)	(29,462,411)	88,702,151
Total investment income (loss)	$ 341,029	$ (259,077)	$ 81,952	$ 113,808,568
Contributions:				
Employees	$ 45,736,028	$ 3,433,610	$ 49,169,638	$ 59,302,100
Transfers from other plans				64,160
From other systems	254,019		254,019	322,665
Total contributions	$ 45,990,047	$ 3,433,610	$ 49,423,657	$ 59,688,925
Miscellaneous income	$ 805,471	$ 928	$ 806,399	$ 683,888
Total additions (deductions)	$ 47,136,548	$ 3,175,461	$ 50,312,009	$ 174,181,381
Deductions from Net Assets Attributed to				
Benefits paid to participants	$ 87,800,865	$ 3,110	$ 87,803,975	$ 63,506,079
Administrative and investment expenses	3,896,641	2,758	3,899,399	2,604,457
Refunds and payments to other systems	136,221,791	76	136,221,867	66,664,389
Total deductions	$ 227,919,297	$ 5,944	$ 227,925,241	$ 132,774,925
Net Increase (Decrease)	$ (180,782,749)	$ 3,169,517	$ (177,613,232)	$ 41,406,456
Plan Net Assets				
Beginning of fiscal year	1,764,910,216		1,764,910,216	1,723,503,760
End of fiscal year	$ 1,584,127,467	$ 3,169,517	$ 1,587,296,984	$ 1,764,910,216

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

Note 1 Summary of Significant Accounting Policies

The State of Michigan 457 Plan is a deferred compensation plan sponsored by the State of Michigan. The Plan covers employees of the State of Michigan and qualifying members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010. 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. Employer contributions for qualifying members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010 are reported in the 401K Plan. 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 (GASB). 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 3 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 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. The Plan was further amended by Act 75, P.A. 2010, to include public school reporting units and applicable members as participants in the Plan.

Eligibility - All State of Michigan employees and qualified members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010 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 into 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 contributions. 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 or applicable public school 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 that 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 roll over all or a portion of their account balances to other qualified plans upon leaving State service. Upon leaving State service, State of Michigan participants may also use all or a portion of their account balances to purchase preapproved service credit in the State of Michigan's Defined Benefit Retirement Plan.

Note 3 **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, SSgA S&P 500 Index Fund, SSgA S&P Mid Cap Index Fund, SSgA Russell 2000 Index Fund, SSgA Target Retirement Income Fund, and SSgA Target Retirement Funds ranging in retirement dates from 2010 through 2055.

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, 2011 and September 30, 2010, 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)
2011		
Stable Value Fund:		
Traditional GICs *	$ 18,191,643	0.61
Synthetic contracts *	$647,940,842	3.81
SSgA STIF *	$ 74,873,307	0.05
Common trust funds:		
SSgA Bond Market Index Fund	$ 86,066,204	7.16
SSgA Yield Enhanced STIF	$ 22,901,014	0.00
Mutual funds:		
PIMCO Total Return Fund	$ 38,739,625	8.97
MFS Total Return Fund	$ 15,562,622	6.39
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

* 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
2011			
Stable Value Fund:			
Traditional GICs *	$ 18,191,643	A to A+	S&P
Synthetic contracts *	$647,940,842	NR to AAA	S&P
SSgA STIF	$ 74,873,307	A1/P1 to Aaa	Moody's
Common trust funds:			
SSgA Bond Market Index Fund	$ 86,066,204	Baa to Aaa	Moody's
SSgA Yield Enhanced STIF	$ 22,901,014	NR	
Mutual funds:			
PIMCO Total Return Fund	$ 38,739,625	Below B to AAA	S&P
MFS Total Return Fund	$ 15,562,622	NR to AAA	S&P
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

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

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
2011		
Mutual funds:		
American Funds EuroPacific Growth Fund	Various	$102,197,498
SSgA Emerging Markets Fund	Various	$ 43,242,585
PIMCO Total Return Fund	Various	$ 38,739,625
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

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, 2011 and September 30, 2010:

	Fair Value at September 30	
	2011	2010
SGIC Components:		
Underlying investments	$679,935,307	$752,654,027
Wrap contract		
Total	$679,935,307	$752,654,027

Note 4 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 5 Accounting Change

During fiscal year 2009-10, the Plan implemented 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 3 includes disclosure regarding fully benefit responsive SGICs held as investments of the Plan. No other types of derivative instruments were held by the Plan during fiscal years 2010-11 and 2009-10.

Note 6 Subsequent Events

Effective December 15, 2011, Acts 264 and 265, P.A. 2011, amended the State Employees' Retirement Act (Act 240, P.A. 1943). These changes could significantly impact member benefits and future activity of the State of Michigan 457 Plan. A summary of the key changes is as follows:

a. Provides for a refund of the 3 percent member contributions withheld under Act 185, P.A. 2010. Contributions totaling $81.5 million as of September 30, 2011 were reported as amounts held in custody for others. State of Michigan members have the option to roll over all or a portion of their refunds into the 401K or 457 Plans.

b. Provides existing defined contribution plan members with the option to retain the current retirement graded premium health insurance plan for retiree health care or choose a portable Personal Healthcare Fund, which can be used to pay healthcare expenses in retirement. Defined contribution plan members electing to switch to the Personal Healthcare Fund would monetize existing years of service for deposit into the 401K or 457 Plans and members would receive an employer match up to 2 percent of future compensation.

c. Eliminates retiree health insurance for employees hired on or after January 1, 2012 and replaces it with a portable Personal Healthcare Fund. Employees would receive an employer match of up to 2 percent of compensation plus a lump sum deposit of either $1,000 or $2,000 upon termination of employment. Both the Personal Healthcare Fund and lump sum deposit will be included in the 401K and 457 Plans.

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

Dear Mr. Nixon and Mr. Stoddard:

We have audited the basic financial statements of the State of Michigan 457 Plan as of and for the fiscal years ended September 30, 2011 and September 30, 2010, as identified in the table of contents, and have issued our report thereon dated May 11, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Plan is responsible for establishing and maintaining effective 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.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined in the preceding paragraph. However, we identified a deficiency in internal control over financial reporting, as described in Finding 1, that we consider to be a significant deficiency in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the 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, and 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.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General
May 11, 2012

FINDING, RECOMMENDATION, AND AGENCY PRELIMINARY RESPONSE

FINDING

1. Controls Over Financial Reporting

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, contributions and benefit payments were understated by $7.4 million during fiscal year 2010-11.

Section 18.1485 of the *Michigan Compiled Laws* requires each department to establish and maintain an internal accounting and control system using generally accepted accounting principles* for revenue and expenses. Internal control is a process, effected by management and other personnel, designed to provide reasonable assurance regarding the reliability of the financial records. ORS contracts with a third party administrator (TPA) to provide recordkeeping, administrative, custodial, and educational 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 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 determined that 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. Financial Services did not account for the activity in which a deceased participant's account was distributed to his or her beneficiaries and the beneficiaries elected to contribute the funds to their accounts with the TPA. As a result of Financial Services not including this activity, contributions and benefit payments were understated by $7.4 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.

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

AGENCY PRELIMINARY RESPONSE

The Department of Technology, Management, and Budget (DTMB) agrees with the recommendation but notes that the participant accounts are accurately stated with the TPA. DTMB informed us that the 457 Plan statement preparation processes and procedures have seen significant improvement. DTMB indicated that processes and procedures will be reviewed and modified as necessary to improve and enhance existing internal control for determining the proper recording and reporting of financial information for the Plan. Also, DTMB stated that meetings among the TPA, ORS, and Financial Services to define the reporting and data requirements of the Plan are ongoing. In addition, DTMB stated that new or enhanced monthly reports have been provided by the TPA and are being thoroughly reviewed, tested, and verified by DTMB. Any other process improvements are expected to be implemented by August 2012.

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.
DTMB	Department of Technology, Management, and Budget.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial statements of an audited entity are presented fairly in all material respects in conformity with the disclosed basis of accounting.
generally accepted accounting principles (GAAP)	A technical accounting term that encompasses the conventions, rules, guidelines, and procedures necessary to define accepted accounting practice at a particular time; also cited as "accounting principles generally accepted in the United States of America."
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.

IRC	Internal Revenue Code.
material misstatement	A misstatement in the financial statements that causes the statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.
material weakness in internal control over financial reporting	A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected, on a timely basis.
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 statements presenting the basic financial information of the audited entity are fairly presented in conformity with the disclosed basis of accounting.

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