MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

FINANCIAL AUDIT
OF THE

STATE OF MICHIGAN 401K PLAN

October 1, 2009 through September 30, 2011

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

071-0156-12

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 401K Plan

October 1, 2009 through September 30, 2011

Report Number:
071-0156-12

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 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 substantially 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, and Budget's preliminary response indicates that it agrees 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 401(k) 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 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 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.

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 pension 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. Employee contributions for qualifying members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010 are reported in the 457 Plan. 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

Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

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

Scott M. Strong, C.P.A., C.I.A.
Deputy Auditor General

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

June 13, 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 401K 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

071-0156-12

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STATE OF MICHIGAN
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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 401K 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 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, 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 401K 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 6, in 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 9 through 12 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 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 year 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	$2,996,783,435	$3,064,806,119	$2,750,169,790
Net investment gain (loss)	$ (36,683,568)	$ 236,684,112	$ 34,916,337
Contributions - Employees	158,717,890	154,933,900	147,398,721
Contributions - Employers	102,771,683	95,913,133	89,882,688
Contributions - From other plans	146,926		
Contributions - From other systems	5,923,257	5,232,620	2,490,231
Benefits paid	(99,572,124)	(84,140,622)	(80,994,650)
Refunds and payments to other systems	(193,829,667)	(91,468,066)	(68,105,544)
Other income and expenses	(5,497,081)	(2,518,751)	(6,726,435)
Net Increase (Decrease) in Plan Net Assets	$ (68,022,684)	$ 314,636,328	$ 118,861,348

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, benefits paid and refunds and payments to other systems increased in the 401K Plan in fiscal year 2010-11.

Overall Fund Structure and Objectives

The Plan was established by the Civil Service Commission in 1985 as a 401(k) 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 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 was amended in 2010 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 on or after July 1, 2010. These participants are pension plus members and their employer contributions and related activity are accounted for in the Plan as outlined in the Plan Document. The employee contributions for these members are accounted for in the State of Michigan 457 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 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

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 25.0 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 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 loss of $36.7 million or 1.2 percent of beginning net assets as compared to fiscal year 2009-10, which posted a net investment gain of $236.7 million or 8.6 percent of beginning 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 401K PLAN

Statement of Plan Net Assets

	September 30, 2011				September 30, 2010
	State of Michigan Defined Contribution Retirement Fund	State of Michigan 401k Deferred Compensation Fund	Public School Defined Contribution Fund	Total	Total
Assets					
Equity in common cash	$ 221,381	$ 1,119,520	$	$ 1,340,901	$ 983,899
Participant-directed investments, at fair value/contract value (Note 4):					
Stable Value Fund	142,328,345	356,126,212	200	498,454,757	503,719,660
ING Small Cap Growth Equity Fund	54,083,725	36,273,974	710	90,358,409	102,332,506
Mutual funds	439,925,408	457,213,836	7,549	897,146,793	1,014,756,492
Common trust funds	722,799,957	477,433,575	1,309,651	1,201,543,183	1,127,538,209
Tier III investments	53,747,897	38,158,215		91,906,112	97,785,179
Participant loans	145,898,828	73,180,428		219,079,256	217,311,286
Other receivable	254,601	246,080	105,199	605,880	378,887
Total assets	$ 1,559,260,142	$ 1,439,751,840	$ 1,423,309	$ 3,000,435,291	$ 3,064,806,119
Liabilities					
Amounts due to other funds	$ 3,651,856	$	$	$ 3,651,856	$ 0
Total liabilities	$ 3,651,856	$ 0	$ 0	$ 3,651,856	$ 0
Plan Net Assets	$ 1,555,608,286	$ 1,439,751,840	$ 1,423,309	$ 2,996,783,435	$ 3,064,806,119

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				
	2011				2010
	State of Michigan Defined Contribution Retirement Fund	State of Michigan 401k Deferred Compensation Fund	Public School Defined Contribution Fund	Total	Total
Additions to Net Assets					
Investment income (loss):					
Interest and dividends	$ 19,504,790	$ 23,211,385	$ 9,882	$ 42,726,057	$ 33,795,503
Net appreciation (depreciation) in fair value of investments	(48,351,227)	(30,923,208)	(135,190)	(79,409,625)	202,888,609
Total investment income (loss)	$ (28,846,437)	$ (7,711,823)	$ (125,308)	$ (36,683,568)	$ 236,684,112
Contributions:					
Employees	$ 81,470,207	$ 77,247,683	$	$ 158,717,890	$ 154,933,900
Employers	101,221,735		1,549,948	102,771,683	95,913,133
Transfers from other plans	6,977	139,949		146,926	5,131,964
From other systems	5,421,810	501,447		5,923,257	5,232,620
Total contributions	$ 188,120,729	$ 77,889,079	$ 1,549,948	$ 267,559,756	$ 261,211,618
Miscellaneous income	$ 588,472	$ 596,018	$ 0	$ 1,184,490	$ 1,043,276
Total additions (deductions)	$ 159,862,764	$ 70,773,274	$ 1,424,640	$ 232,060,678	$ 498,939,006
Deductions from Net Assets					
Benefits paid to participants	$ 42,855,555	$ 56,716,569	$	$ 99,572,124	$ 84,140,622
Administrative and investment expenses	3,440,410	3,194,463		6,634,873	7,181,563
Transfers to other plans	8,716	36,651	1,331	46,698	1,512,428
Refunds and payments to other systems	52,833,035	140,996,632		193,829,667	91,468,066
Total deductions	$ 99,137,716	$ 200,944,315	$ 1,331	$ 300,083,362	$ 184,302,678
Net Increase (Decrease)	$ 60,725,048	$ (130,171,041)	$ 1,423,309	$ (68,022,684)	$ 314,636,328
Plan Net Assets					
Beginning of fiscal year - Restated (Note 3)	1,494,883,238	1,569,922,881		3,064,806,119	2,750,169,790
End of fiscal year	$ 1,555,608,286	$ 1,439,751,840	$ 1,423,309	$ 2,996,783,435	$ 3,064,806,119

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 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 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. Employee contributions for qualifying members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010 are reported in the 457 Plan. 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 (GASB). 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. 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 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, 2011, there were 38,214 State of Michigan participants in the Plan. 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. As of September 30, 2011, there were 17,003 public school participants in the Plan.

Eligibility - All employees of the State of Michigan become eligible to participate on the first day of employment in the 401k component of the Plan. State of Michigan employees hired on or after March 31, 1997 and qualifying members of the Michigan Public School Employees' Retirement System hired on or after July 1, 2010 who elect to participate 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 401(k) 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 401k deferred compensation component of the Plan.

The Plan further provides for eligible public school reporting units to make a mandatory contribution of 50.0 percent of participants' voluntary contributions up to 1.0 percent. Participants are 100 percent vested in their salary deferrals at all times and vest in the employer contributions based on years of service.

Contributions From Other Systems - Active employees may roll over 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 State of Michigan participant's account is credited with his or her employee contributions; the State's contributions, if applicable; and an allocation of the Plan's earnings. Each public school pension plus participant's account is credited with his or her employer contributions, if applicable, and an allocation of the Plan's earnings. In either case, 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 - State of Michigan 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. Public school participants were not eligible to borrow from their vested account during fiscal year 2010-11.

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 the 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 2010-11 deemed distributed loans totaled $2.4 million for defined contribution retirement participants and $.5 million for 401k deferred compensation participants at September 30, 2011.

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, 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 roll over all or a portion of their funds to other qualified plans upon leaving State service. Participants in the 401k deferred compensation component may 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 2010-11, $3.7 million of employer contributions was identified as amounts due 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 2010-11, these participants were moved to the 401k deferred compensation component of the Plan.

Forfeited Accounts - Forfeited nonvested accounts totaled $5.8 million and $9.5 million at September 30, 2011 and September 30, 2010, 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 State employees defined contribution retirement plan members are currently included in the actuarial valuation provided by the State Employees' Retirement System and reported in the State Employees' Retirement System's financial statements. OPEB for public school pension plus employees defined benefit plan members is currently included in the actuarial valuation provided by the Michigan Public School Employees' Retirement System and reported in the Michigan Public School Employees' Retirement System's financial statements. For more information regarding these benefits, please refer to the separately issued retirement system comprehensive annual financial reports.

Note 3 <u>Restatement</u>

During fiscal year 2010-11, it was noted that some Plan participants were accounted for in the State of Michigan Deferred Compensation Fund component of the Plan and should have been accounted for in the State of Michigan Defined Contribution Retirement Fund component of the Plan. As a result, beginning net assets were restated, decreasing beginning net assets in the State of Michigan Deferred Compensation Fund by $13.7 million and increasing beginning net assets in the State of Michigan Defined Contribution Retirement Fund. There was no effect on the Plan as a whole.

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, SSgA S&P 500 Index Fund, SSgA S&P MidCap 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 within the 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 concentration of credit risk or custodial 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)
2011		
Stable Value Fund:		
Traditional GICs *	$ 12,237,023	0.61
Synthetic contracts *	$435,852,159	3.81
SSgA STIF*	$ 50,365,235	0.05
Common trust funds:		
SSgA Bond Market Index Fund	$210,964,520	7.16
SSgA Yield Enhanced STIF	$179,850,158	0.00
Mutual funds:		
PIMCO Total Return Fund	$ 85,841,842	8.97
MFS Total Return Fund	$ 57,121,449	6.39
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

* 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 *	$ 12,237,023	A to A+	S&P
Synthetic contracts *	$435,852,159	NR to AAA	S&P
SSgA STIF*	$ 50,365,235	A1/P1 to Aaa	Moody's
Common trust funds			
SSgA Bond Market Index Fund	$210,964,520	Baa to Aaa	Moody's
SSgA Yield Enhanced STIF	$179,850,158	Other	S&P
Mutual funds:			
PIMCO Total Return Fund	$ 85,841,842	Below B to AAA	S&P
MFS Total Return Fund	$ 57,121,449	NR to AAA	S&P
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

* 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	$224,383,100
SSgA Emerging Markets Fund	Various	$104,765,688
PIMCO Total Return Fund	Various	$ 85,841,842
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

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	$457,373,964	$462,235,755
Wrapper contract		
Total	$457,373,964	$462,235,755

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 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 of the Plan. No other types of derivative instruments were held by the Plan during fiscal years 2010-11 and 2009-10.

Note 7 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 401K 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. Provide existing defined benefit plan members with the option to either remain in the defined benefit plan and pay 4 percent of their compensation into the plan or freeze their pension benefit and continue their future service under the defined contribution retirement plan. Those members who choose to continue their future service under the defined contribution plan will have the same contribution provisions as State of Michigan members hired after March 31, 1997 (see Note 2, Contributions).

c. Provides existing defined contribution retirement 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 retirement 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.

d. 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
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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 401K 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 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 State of Michigan 401K 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.

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, 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, we identified several financial statement errors during our audit that, when brought to Financial Services' attention, were substantially corrected.

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 401K 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 identified the following reporting weaknesses:

a. Financial Services did not use the correct methodology to classify investments on the Plan's statement of net assets. As a result of our audit procedures, Financial Services revised its methodology and correctly classified the investments as of September 30, 2011. Prior to the correction, the financial statements had the following investment classification errors:

   (1) Understatement of the mutual funds investments by $184.5 million.

   (2) Overstatement of the common trust funds investments by $184.5 million.

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

b. Financial Services did not properly classify investment activity and administrative expenses as reported by the TPA and custodian. As a result of our audit procedures, Financial Services corrected the accounting for this activity. Prior to the correction, the financial statements had the following classification errors for fiscal year 2010-11:

(1) Understatement of net appreciation (depreciation) in fair value of investments by $21.1 million.

(2) Overstatement of interest and dividends income by $26.0 million.

(3) Overstatement of administrative and investment expenses by $5.0 million.

c. ORS and Financial Services did not ensure that participant retirement codes reported by the State were correct, and as a result, the TPA assigned participants to the incorrect fund. Our audit procedures identified defined contribution retirement fund participants that should have been deferred compensation fund participants. When brought to its attention, the TPA reclassified 216 participants and their approximately $16.8 million in investment balances from the defined contribution retirement fund to the 401k deferred compensation fund.

d. Financial Services did not properly restate the beginning plan net assets when it reclassified participants from the 401k deferred compensation fund to the defined contribution retirement fund. As a result of our audit procedures, Financial Services corrected the accounting for this activity. Prior to the correction, the beginning of fiscal year plan net assets balance for the 401k deferred compensation fund was overstated by $8.3 million and the defined contribution retirement fund was understated by $7.6 million because of the following reasons:

(1) Financial Services improperly reclassified $4.3 million of participant investments from the defined contribution retirement fund to the 401k deferred compensation fund; however, these participants had already been reclassified by the TPA.

(2) Financial Services improperly reclassified $3.9 million of participant investments relating to employer contributions from the defined contribution retirement fund to the 401k deferred compensation fund when they moved the participants. However, these employer contributions should have remained in the defined contribution retirement fund in order to be forfeited to the State.

(3) Financial Services recorded $.7 million of prior period investment activity for the defined contribution retirement fund during the current fiscal year.

e. 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:

(1) Financial Services did not make an adjustment for participants' loans that were written off by the Plan in prior years but were reported by the TPA as benefit payments in the current year in order for the TPA to adjust its records for these loans. As a result of our audit procedures, Financial Services corrected its accounting for this loan activity. Prior to the correction, participant loans as of September 30, 2011 were understated and benefit payments for fiscal year 2010-11 were overstated by $2.5 million.

(2) 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 $3.4 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.

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 401K 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.

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.
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 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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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL