MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

FINANCIAL AUDIT
OF THE

STATE OF MICHIGAN 401K PLAN

Fiscal Years Ended September 30, 2012 and September 30, 2011

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

071-0156-13

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

Fiscal Years Ended September 30, 2012 and September 30, 2011

Report Number:
071-0156-13

Released:
May 2013

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 did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, we did identify significant deficiencies (Findings 1 and 2).

The Office of Retirement Services (ORS) and Financial Services, within the Department of Technology, Management, and Budget (DTMB), did not have sufficient controls to ensure that they properly recorded the State of Michigan 401K Plan's financial activity (Finding 1).

ORS and Financial Services did not adhere to established deadlines to ensure that they recorded the State of Michigan 401K Plan's financial activity and prepared drafts of the Plan's statements and notes timely (Finding 2).

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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*. However, we noted an instance of other noncompliance (Finding 2).

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Agency Response:

Our audit report includes 2 findings and 2 corresponding recommendations. DTMB's preliminary response indicates that it agrees with the recommendations.

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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) deferred compensation plan and amended in March 1997 to implement a defined contribution retirement fund as a means for employees to save for retirement.

The Plan covers employees of the State of Michigan, employees of the Michigan public school reporting units hired on or after July 1, 2010, and employees of the Education Achievement Authority. Employees of the State become eligible to participate in the Plan on the first day of employment and may voluntarily contribute a portion of their compensation up to the established Internal Revenue Code limits.

The Plan provides for the State to make a mandatory contribution of 4.0% and matching contributions up to a maximum of 3.0% of each participant's compensation for employees not covered by the State's defined benefit pension plans.

In addition, the Plan provides for public school reporting units to make a mandatory contribution of 50% of eligible participants' voluntary contributions up to 1%. The Plan also provides for the Education Achievement Authority to make a mandatory contribution of 100% of participants' voluntary contributions up to 7.5%.

Finally, the Plan provides for the Personal Healthcare Fund for State employees hired on or after January 1, 2012 to account for an employer match of up to 2% of compensation. State of Michigan employees hired prior to January 1, 2012 and who opted out of the graded premium benefit receive an employer match of up to 2% of future compensation plus a monetized amount for existing years of service upon terminating employment.

Participants are 100% vested in their contributions and related earnings or losses at all times and vest in the employer contributions and related earnings or losses based on years of service.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: http://audgen.michigan.gov

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201 N. Washington Square
Lansing, Michigan 48913

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

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

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

May 3, 2013

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 fiscal years ended September 30, 2012 and 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 findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

The agency preliminary responses were 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 recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

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

Sincerely,

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

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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 401K Plan as of and for the fiscal years ended September 30, 2012 and September 30, 2011, 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, 2012 and September 30, 2011 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, 2012 and September 30, 2011 and the changes in its plan net assets for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 28, 2013 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.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 11 through 14 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General
February 28, 2013

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section presents our discussion and analysis of the State of Michigan 401K Plan's (the Plan's) financial performance and provides an overview of the Plan's financial activities for the fiscal years ended September 30, 2012, September 30, 2011, and September 30, 2010. This section should be read in conjunction with the Plan's basic financial statements.

Using This Annual Financial Report

This annual financial report consists of two parts: (1) management's discussion and analysis (this section) and (2) the Plan's 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 Years Ended September 30		
	2012	2011	2010
Plan Net Assets	$3,554,739,043	$ 2,996,783,435	$3,064,806,119
Net investment gain (loss)	$ 500,943,633	$ (36,683,568)	$ 236,684,112
Contributions - Employees	145,546,154	158,717,890	154,933,900
Contributions - Employers	116,358,114	102,771,683	95,913,133
Contributions - From other plans	2,567,605	146,926	
Contributions - From other systems	6,824,154	5,923,257	5,232,620
Benefits paid	(92,174,834)	(99,572,124)	(84,140,622)
Refunds and payments to other systems	(111,246,001)	(193,829,667)	(91,468,066)
Other income and expenses - net	(10,070,866)	(5,497,081)	(2,518,751)
Net Increase (Decrease) in Plan Net Assets	$ 558,747,960	$ (68,022,684)	$ 314,636,328

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 State of Michigan 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) deferred compensation plan and amended in March 1997 to implement a defined contribution component as a means for State employees to save for retirement. Employees of the State of Michigan are eligible to participate in the Plan as of 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 fiscal year 2009-10 to expand the definition of employer to include Michigan public school reporting units and participants to include members of the Michigan Public School Employees' Retirement System (MPSERS) hired on or after July 1, 2010. These participants are offered the pension plus plan that includes both defined benefit and defined contribution retirement benefits. The defined benefit component is accounted for in MPSERS. For the defined contribution component, participant contributions are accounted for in the State of Michigan 457 Plan and employer contributions are accounted for in the State of Michigan 401K Plan as specified in the Plan Documents.

Effective December 15, 2011, Acts 264 and 265, P.A. 2011, amended the State Employees' Retirement Act (Act 240, P.A. 1943) and the Public Employee Retirement Health Care Funding Act (Act 77, P.A. 2010), respectively. The change provided for a refund of the 3% member contributions withheld under Act 185, P.A. 2010, and gave employees the option to contribute all or a portion of their refunds into the State of Michigan 401K Plan or 457 Plan. This amendment also provided existing defined contribution retirement plan participants with the option to retain the current retiree health insurance plan or to choose a portable personal healthcare fund, which may be used to pay healthcare expenses in retirement. The defined contribution plan participants who elected to switch to a personal healthcare fund would monetize existing years of service for deposit into the State of Michigan 401K Plan or 457 Plan and would receive an employer match of up to 2% of future compensation. The amendment also eliminated the retiree health insurance plan for employees hired on or after January 1, 2012 and replaced it with a portable personal healthcare fund in which employees receive an employer match of up to 2% of compensation that is deposited into the State of Michigan 401K Plan or 457 Plan.

During fiscal year 2011-12, an interlocal agreement between the Education Achievement Authority (EAA) and the Department of Technology, Management, and Budget allowed EAA employees to participate in the State of Michigan 401K Plan and 457 Plan.

Effective September 4, 2012, Act 300, P.A. 2012, provided public school employees with options on future retirement pension benefits. Existing defined benefit participants could elect to freeze pension benefits earned to date and move to the defined contribution plan for future years of service. Employees hired on or after September 4, 2012 could elect the defined contribution plan instead of the current pension plus plan.

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. Plan assets may be invested and reinvested in various instruments as deemed appropriate by the trustee and Plan management. Several investment tiers have been developed and made available to participants. A summary of the types of investments is listed in Note 4.

Investment Results

Despite a declining global economy and a looming fiscal battle in the legislative chambers of Washington, D.C., the collective enthusiasm of the markets in the quarter ended September 30, 2012 was unshaken in anticipation of global central banks' support of the European Central Bank's introduction in early September of the Outright Monetary Transactions program.

Although there have been no bonds purchased through the Outright Monetary Transactions program to date, the U.S. Federal Reserve plans to buy $40 billion of mortgage-backed securities each month until the job market improves substantially and also announced that it would keep the federal funds rate near zero through at least mid-2015 and maintain these low rates even after the economy begins to build momentum.

For international markets, the Morgan Stanley Capital International (MSCI) Europe, Australasia, and Far East Index was up 6.1% led by Europe. The MSCI Emerging Markets Index surged 7.0% in the quarter ended September 30, 2012, led by Europe, and Treasury rates were mixed during the quarter. Yield on the benchmark ten-year Treasury note closed in September 2012 at 1.65%. Yields on money market instruments remained very low throughout September 2012 as the federal funds target rate traded within the 0.00% - 0.25% range.

By the time fiscal year 2011-12 closed, the Plan posted a net investment gain of $500.9 million or 16.7% of beginning net assets as compared to fiscal year 2010-11, which posted a net investment loss of $36.7 million or 1.2% of beginning net assets.

For fiscal year 2010-11, U.S. Treasury bills as a whole were up 6.5% and long bonds gained 25%. Although 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 September 2011 as the federal funds target rate traded within the 0.00% - 0.25% range.

Contacting Management

This report is designed to provide the retirement board, Plan participants, 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

			As of
	State of Michigan Defined Contribution Retirement Fund	State of Michigan 401k Deferred Compensation Fund	State of Michigan Personal Healthcare Fund
Assets			
Equity in common cash	$ 458,951	$ 1,102,419	$
Participant-directed investments, at fair value/contract value (Note 4):			
Stable Value Fund	145,440,349	350,598,621	305,346
ING Small Cap Growth Equity Fund	60,052,175	47,011,545	105,041
Mutual funds	517,563,300	519,234,511	1,092,812
Common trust funds	978,236,691	603,145,481	3,758,005
Tier III investments	57,797,057	46,263,423	14,660
Participant loans	150,929,545	69,194,840	57,959
Other receivable	191,187	164,435	249,888
Total assets	$ 1,910,669,254	$ 1,636,715,275	$ 5,583,711
Liabilities			
Accounts payable	$	$ 900,276	$
Amounts due to other funds	1,559,471		
Total liabilities	$ 1,559,471	$ 900,276	$ 0
Plan Net Assets	$ 1,909,109,783	$ 1,635,814,999	$ 5,583,711

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

September 30, 2012			As of September 30, 2011
Public School Defined Contribution Fund	Education Achievement Authority Defined Contribution Fund	Total	Total
$ 56,922	$	$ 1,618,292	$ 1,340,901
614		496,344,930	498,454,757
2,316		107,171,077	90,358,409
26,528		1,037,917,151	897,146,793
3,938,873	58,839	1,589,137,889	1,201,543,183
		104,075,140	91,906,112
		220,182,344	219,079,256
146,459		751,969	605,880
$ 4,171,711	$ 58,839	$ 3,557,198,790	$ 3,000,435,291
$	$	$ 900,276	$
		1,559,471	3,651,856
$ 0	$ 0	$ 2,459,747	$ 3,651,856
$ 4,171,711	$ 58,839	$ 3,554,739,043	$ 2,996,783,435

STATE OF MICHIGAN 401K PLAN

Statement of Changes in Plan Net Assets

	Fiscal Year Ended		
	State of Michigan Defined Contribution Retirement Fund	State of Michigan 401k Deferred Compensation Fund	State of Michigan Personal Healthcare Fund
Additions to Net Assets			
Investment income (loss):			
Interest and dividends	$ 20,670,287	$ 21,528,738	$ 10,559
Net appreciation (depreciation) in fair value of investments	247,727,687	210,368,305	160,654
Total investment income (loss)	$ 268,397,974	$ 231,897,043	$ 171,213
Contributions:			
Employees	$ 89,406,096	$ 53,889,654	$ 2,250,404
Employers	110,145,613		3,462,279
Transfers from other plans	833	2,566,772	
From other systems	5,918,756	905,398	
Total contributions	$ 205,471,297	$ 57,361,824	$ 5,712,682
Miscellaneous income	$ 651,670	$ 598,580	$
Total additions	$ 474,520,941	$ 289,857,447	$ 5,883,895
Deductions from Net Assets			
Benefits paid to participants	$ 49,383,720	$ 42,664,203	$ 126,542
Administrative and investment expenses	4,625,961	3,702,477	11,238
Transfers to other plans	2,566,772	833	
Refunds and payments to other systems	45,344,017	65,733,397	162,405
Total deductions	$ 101,920,470	$ 112,100,910	$ 300,185
Net Increase (Decrease)	$ 372,600,471	$ 177,756,537	$ 5,583,711
Plan Net Assets			
Beginning of fiscal year	$ 1,555,608,286	$ 1,439,751,840	$
Prior period adjustments (Note 3)	(19,098,974)	18,306,622	
Beginning of fiscal year - Restated	$ 1,536,509,312	$ 1,458,058,462	$
End of fiscal year	$ 1,909,109,783	$ 1,635,814,999	$ 5,583,711

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

September 30, 2012			Fiscal Year Ended September 30, 2011
Public School Defined Contribution Fund	Education Achievement Authority Defined Contribution Fund	Total	Total
$ 343	$ 86	$ 42,210,013	$ 42,726,057
476,054	921	458,733,621	(79,409,625)
$ 476,397	$ 1,006	$ 500,943,633	$ (36,683,568)
$	$	$ 145,546,154	$ 158,717,890
2,692,390	57,833	116,358,114	102,771,683
		2,567,605	146,926
		6,824,154	5,923,257
$ 2,692,390	$ 57,833	$ 271,296,026	$ 267,559,756
$	$	$ 1,250,250	$ 1,184,490
$ 3,168,787	$ 58,839	$ 773,489,909	$ 232,060,678
$ 369	$	$ 92,174,834	$ 99,572,124
413,834		8,753,510	6,634,873
		2,567,605	46,698
6,182		111,246,001	193,829,667
$ 420,385	$ 0	$ 214,741,950	$ 300,083,362
$ 2,748,402	$ 58,839	$ 558,747,960	$ (68,022,684)
$ 1,423,309	$	$ 2,996,783,435	$ 3,064,806,119
		(792,352)	
$ 1,423,309	$	$ 2,995,991,083	$ 3,064,806,119
$ 4,171,711	$ 58,839	$ 3,554,739,043	$ 2,996,783,435

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 is considered part of the State and is included in the *State of Michigan Comprehensive Annual Financial Report* as a pension (and other employee benefit) trust fund.

The Plan covers employees of the State of Michigan; employees of the Michigan public school reporting units hired on or after July 1, 2010; and employees of the Education Achievement Authority (EAA). Act 264, P.A. 2011, established a Personal Healthcare Fund within the Plan for State employees, which can be used to pay healthcare expenses in retirement.

Basis of Presentation - The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board. The accompanying financial statements present only the State of Michigan 401K Plan. Accordingly, they do not purport to, and do not, present fairly the financial position and the changes in financial position of the State of Michigan as a whole or its pension (and other postemployment 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 based on 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 managed by State Street Global Advisors (SSgA) and Rainier Investment Management, similar to mutual funds though not registered like mutual funds. The 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 description provides only general information. Participants should refer to the Plan Document for a more complete description of the Plan's provisions. The Plan Document is available on the State of Michigan Office of Retirement Services' Web site.

General - The Plan was established by the Civil Service Commission in 1985 as a 401k deferred compensation plan. The Plan was amended as of March 31, 1997 to implement a defined contribution retirement fund. The Plan Document was last amended and restated effective January 1, 2012 to incorporate all amendments, update changes required by law, and add new sections for changes in provisions made during the Plan year. As of September 30, 2012, the Plan included 41,828 State of Michigan participants, 30,108 Michigan public school participants, and 24 EAA participants.

Eligibility - Employees of the State of Michigan are eligible to participate in the 401K deferred compensation fund on the first day of employment. State of Michigan employees hired on or after March 31, 1997, public school employees hired on or after July 1, 2010, and EAA employees are eligible to participate in the defined contribution retirement fund on the first day of employment. Also, State of Michigan employees hired prior to March 31, 1997 could have become eligible to participate in the defined contribution retirement fund if they had irrevocably elected to forgo participation in the State's defined benefit pension plans.

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.

Also, for State of Michigan employees participating in the defined contribution retirement fund and who are not covered by the State's defined benefit pension plans, the Plan provides for the State of Michigan to make a mandatory contribution of 4.0% plus a matching contribution of up to 3.0% of each participant's compensation. The State does not make matching contributions for employees in the deferred compensation component of the Plan.

In addition, the Plan provides for public school reporting units to make a mandatory contribution of 50% of eligible participants' voluntary contributions up to 1%. The Plan also provides for the EAA to make a mandatory contribution of 100% of participants' voluntary contributions up to 7.5%.

Finally, the Plan provides for the Personal Healthcare Fund for State of Michigan employees hired on or after January 1, 2012 to account for employee contributions and an employer match of up to 2% of compensation. State of Michigan employees hired prior to January 1, 2012 and who opted out of the graded premium benefit receive an employer match of up to 2% of future compensation plus a monetized amount for existing years of service upon terminating employment.

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 Plan. Participants may withdraw funds rolled into the Plan at any time.

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

Vesting - Participants are 100% vested in their contributions and related earnings or losses at all times. State of Michigan participants are vested in their employer contributions and related earnings or losses based on years of service over a four-year period. A participant is 100% vested after four years of

service credit (a year of service is defined as 2,080 hours). Public school and EAA participants vest in their employer contributions based on years of service.

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 and EAA participants were not eligible to borrow from their vested account during fiscal years 2011-12 and 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. These loans are considered a distribution to the participant for which a federal 1099 tax form is issued. During fiscal years 2011-12 and 2010-11, defaulted loans totaled $4.3 million and $6.1 million, respectively, for participants in the State of Michigan Defined Contribution Retirement Fund and $3.0 million and $11.2 million, respectively, for participants in the State of Michigan 401K Deferred Compensation Fund.

Payment of Benefits - Participants may withdraw their funds upon leaving employment. 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 - Upon leaving employment, participants may roll over all or a portion of their account balances to other qualified plans or use all or a portion of their account balances to purchase preapproved service credit in the State's defined benefit pension plans.

In fiscal year 2010-11, $3.7 million of employer contributions was identified as amounts due to the Michigan State Employees' Retirement System (MSERS) to refund the employer contributions previously made by the State for

participants that were incorrectly placed in the State of Michigan Defined Contribution Fund. In fiscal year 2010-11, these participants were moved to the State of Michigan 401K Deferred Compensation Fund.

Forfeited Accounts - Forfeited nonvested accounts totaled $4.9 million and $5.8 million at September 30, 2012 and September 30, 2011, respectively. Section 401(a)(2) of the Internal Revenue Code restricts the State from recapturing any contributions made to the Plan. Accordingly, as specified in the Plan Document, these accounts are to be 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 is currently included in the actuarial valuation provided by MSERS and reported in the MSERS financial statements. OPEB for public school pension plus employees is currently included in the actuarial valuation provided by the Michigan Public School Employees' Retirement System (MPSERS) and reported in the MPSERS financial statements. For more information regarding these benefits, please refer to the separately issued retirement system comprehensive annual financial reports.

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. Although the Plan has been subsequently amended and restated, management believes that the Plan continues to operate as a qualified trust.

Note 3 Restatement

During fiscal year 2011-12, the accounts of some participants of the State of Michigan 401K Deferred Compensation Fund were reported in the State of Michigan Defined Contribution Retirement Fund in fiscal year 2010-11. As a result, fiscal year 2011-12 beginning net assets have been restated, decreasing the State of Michigan Defined Contribution Retirement Fund beginning net assets by $19.1 million and increasing the State of Michigan 401K Deferred Compensation Fund beginning net assets by $19.1 million.

In addition, fiscal year 2011-12 beginning net assets were restated to account for the previously unrecorded liability related to payments issued to participants of the State of Michigan 401K Deferred Compensation Fund prior to fiscal year 2011-12 that were returned as undeliverable. This prior period adjustment increased the State of Michigan 401K Deferred Compensation Fund accounts payable and decreased the State of Michigan 401K Deferred Compensation Fund beginning net assets by $0.8 million.

Note 4 Investments

All investments are participant directed. The mutual funds are registered with the Securities and Exchange Commission and guaranteed investment contracts (GICs) are regulated by state insurance departments. Several investment tiers have been developed and made available to participants. A brief summary of the types of investments included in each tier follows:

Tier I - Stable Value Fund and common trust funds that include 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 Global All Cap Equity ex-U.S. Index Fund, SSgA Target Retirement Income Fund, and SSgA Target Retirement Funds ranging in retirement dates from 2010 through 2055.

Tier II - ING Small Cap Growth Equity Fund, Rainier Large Cap Growth Equity Fund (a common trust fund), and mutual funds that include MFS Total Return Fund (the MFS Total Return Fund was closed in January 2012 and all investments in this fund were transferred to the Oakmark Equity and Income Fund), Dodge & Cox Stock Fund, Oakmark Equity and Income Fund, T. Rowe Price Mid Cap Value 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 with Tier III are self-managed 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.

Investment Risk:

The Plan's investments are subject to several types of risk. As of September 30, 2012 and September 30, 2011, the Plan did not have any investments subject to 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. As of year-end, the weighted average maturities of investments subject to interest rate risk were as follows:

Investment Type	Fair Value/ Contract Value	Weighted Average Maturity (Years)
2012		
Stable Value Fund:		
Synthetic contracts*	$451,476,744	3.8
SSgA STIF*	$ 44,868,186	0.11
Common trust funds:		
SSgA Bond Market Index Fund	$265,394,340	6.64
SSgA Yield Enhanced STIF	$177,587,675	0.01
Mutual funds:		
PIMCO Total Return Fund	$110,600,281	5.93
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

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

b. Credit Risk

Credit risk is the risk that an issuer or another counterparty to an investment will not fulfill its obligation. 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 subject to credit risk (other than U.S. government securities) were as follows:

Investment Type	Fair Value/ Contract Value	Rating	Rating Organization
2012			
Stable Value Fund:			
Synthetic contracts*	$451,476,744	BBB to AAA	S&P
SSgA STIF*	$ 44,868,186	A1/P1 to Aa	Moody's
Common trust funds:			
SSgA Bond Market Index Fund	$265,394,340	Baa to Aaa	Moody's
SSgA Yield Enhanced STIF	$177,587,675	A1/P1 to Aa	Moody's
Mutual funds:			
PIMCO Total Return Fund	$110,600,281	Below B to AAA	S&P
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

* 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 following investments (other than U.S. government securities) were subject to foreign currency risk:

Investment Type	Foreign Currency	Fair Value
2012		
Mutual funds:		
American Funds EuroPacific Growth Fund	Various	$255,002,062
SSgA Emerging Markets Fund	Various	$106,241,486
PIMCO Total Return Fund	Various	$110,600,281
SSgA Global All Cap Equity ex-US Index Fund	Various	$ 61,886,386
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

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 responsive wrap contract. The wrap contract produces a floating rate of return that is adjusted periodically, but not below zero, to reflect the underlying investment portfolio and generally provide for participant withdrawals at contract value (principal plus accrued interest). Following are the fair values as of September 30, 2012 and September 30, 2011:

	2012	2011
SGIC Components:		
Underlying investments	$481,267,178	$457,373,964
Wrap contract	*	*
Total	$481,267,178	$457,373,964

* The market value of the SGIC's underlying investments was higher than the SGIC's contract value; therefore, the wrap contract does not have a value.

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE

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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, 2012 and September 30, 2011, as identified in the table of contents, and have issued our report thereon dated February 28, 2013. 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 certain deficiencies in internal control over financial reporting, as described in Findings 1 and 2, that we consider to be significant deficiencies 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.* However, we noted an instance of other noncompliance as described in Finding 2.

The agency's preliminary responses to the findings identified in our audit are included in the body of our report. We did not audit the agency's preliminary responses and, accordingly, we express no opinion on them.

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
February 28, 2013

FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

FINDING

1. Properly Recording Financial Activity

The Office of Retirement Services (ORS) and Financial Services, within the Department of Technology, Management, and Budget (DTMB), did not have sufficient controls to ensure that they properly recorded the State of Michigan 401K Plan's financial activity. As a result, they could not ensure the accurate preparation of the Plan's financial statements.

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.

ORS contracted with a third party administrator (TPA) to provide recordkeeping, administration, custodial, and education services for the Plan and had a business partnership agreement with Financial Services to provide accounting and financial reporting services.

Our audit procedures identified the following internal control* weaknesses:

a. ORS and Financial Services did not verify the accuracy of the data provided by the TPA. The TPA provided Financial Services with monthly financial activity reports as well as other detailed information to enable Financial Services to record the Plan's accounting entries and prepare the Plan's annual financial statements. However, the TPAs did not provide ORS and Financial Services with complete and accurate data. As a result, we identified the following financial statement errors as of September 30, 2012:

(1) The TPA did not properly designate 91 Plan participants as deferred compensation fund participants. As a result, the deferred compensation fund investments were understated and the defined contribution retirement fund investments were overstated by $8.2 million.

(2) The TPA did not accurately allocate the investment balances for participants of both the defined contribution retirement fund and the deferred compensation fund. As a result, we estimated that deferred

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

compensation fund investments were understated and Defined Contribution Retirement Fund investments were overstated by $17.4 million.

(3) The TPA provided erroneous detailed information to Financial Services indicating that $4.7 million was due from the Michigan State Employees' Retirement System. As a result, Financial Services recorded the entry, overstating the Plan's accounts receivable and employer contributions by $4.7 million. When brought to its attention, Financial Services corrected this error.

(4) The TPA did not accurately report defaulted participant loans. As a result, benefits paid to participants were understated and payments to other systems were overstated by $0.6 million.

b. Financial Services did not follow its established methodology to properly classify the balances and financial activity of the defined contribution retirement fund and deferred compensation fund participants. As a result:

(1) The restated beginning plan net assets for fiscal year 2011-12 was overstated in the defined contribution retirement fund and understated in the deferred compensation fund by $1.0 million.

(2) Benefit payments and payments to other systems were overstated in the defined contribution retirement fund, and were understated in the deferred compensation fund by $2.5 million and $1.0 million, respectively.

RECOMMENDATION

We recommend that ORS and Financial Services, within DTMB, implement sufficient controls to ensure that they properly record the Plan's financial activity.

AGENCY PRELIMINARY RESPONSE

DTMB agrees with the recommendation but notes that the State's accounting records and the published financial statements were materially accurate. DTMB informed us that Financial Services will, however, revisit existing financial statement preparation and review processes to enhance existing controls and will update the Plan's procedures as needed.

FINDING

2. Adhering to Established Deadlines

ORS and Financial Services did not adhere to established deadlines to ensure that they recorded the State of Michigan 401K Plan's financial activity and prepared drafts of the Plan's financial statements and notes timely. As a result, the Plan's audited financial statements were not finalized until February 28, 2013, two months after the statutory deadline.

Section 18.1492 of the *Michigan Compiled Laws* requires the Plan's financial statements to be audited and submitted to DTMB's Office of Financial Management (OFM) for inclusion in the *State of Michigan Comprehensive Annual Financial Report* within 90 days of the close of the State's fiscal year. Also, to help ensure compliance with this requirement, OFM and Financial Services agreed on deadlines for recording accounting entries and submitting the draft financial statements to OFM. To accomplish this, Financial Services developed a detailed year-end calendar identifying specific completion dates for performing reconciliations and other various procedures necessary to finalize accounting entries; prepare financial statements and note disclosures; and provide draft statements and other necessary information to the auditors.

Financial Services did not adhere to key completion dates as follows:

a. Financial Services did not have all accounting entries recorded by the November 16, 2012 due date. Financial Services recorded the final entries by January 18, 2013, 63 days past the established deadline. These entries included the following:

   (1) An adjustment to restate beginning net assets by $19.1 million, reducing the beginning net assets of the Defined Contribution Retirement Fund and increasing the beginning net assets of the 401k Deferred Compensation Fund.

   (2) Adjustments to eliminate $31.4 million and a negative $30.5 million of activity that was previously recorded as miscellaneous income in the Defined Contribution Retirement Fund and the 401k Deferred Compensation Fund, respectively.

b. Financial Services did not prepare the draft financial statements and note disclosures, and provide them to the auditors, by the November 21, 2012 due date. Financial Services provided the first draft of the financial statements on January 14, 2013, 54 days past the due date and the first draft of the note disclosures on February 1, 2013, 72 days past the due date.

c. Financial Services did not prepare the draft financial statements and note disclosures required for the *State of Michigan Comprehensive Annual Financial Report* and provide them to OFM by the November 26, 2012 due date. Financial Services provided these draft financial statements to OFM on January 16, 2013, 51 days past the due date. Also, Financial Services provided these draft note disclosures to OFM on February 6, 2013, 72 days past the due date.

We noted that the one staff person who is primarily responsible for the State of Michigan 401K Plan's year-end closing process is also responsible for other significant year-end closing processes with equally time sensitive due dates. We noted that this person's work load contributed to the preceding delays.

Also, the auditors had planned the audit and committed sufficient audit resources to be able to meet the statutory deadline based on Financial Services' year-end calendar. However, by the time Financial Services recorded all of the entries and prepared and provided the draft financial statements and notes to the auditors, the auditors had committed a significant portion of the audit resources to other projects that also had statutorily mandated deadlines. Therefore, the auditors could not complete the necessary audit procedures until February 28, 2013.

Because adherence to established completion dates is essential, Financial Services management could consider reallocating staffing resources to ensure that work loads do not adversely affect the timely completion of the year-end closing process.

RECOMMENDATION

We recommend that ORS and Financial Services adhere to established deadlines to ensure that they record the State of Michigan 401K Plan's financial activity and prepare drafts of the Plan's financial statements and notes timely.

AGENCY PRELIMINARY RESPONSE

DTMB agrees with the recommendation but notes that, during the fiscal year, ORS and Financial Services implemented significant changes related to legislative reforms that required new data elements and reporting changes. As a result, significant additional staff effort was required to ensure that the activity was properly reflected in the financial statements. In addition, DTMB notes that all items listed in the finding were related to timeliness and the State's accounting records and the published financial statements were materially accurate. DTMB informed us that Financial Services will, however, revisit existing financial statement preparation and review processes to enhance existing controls and will update Plan time lines to ensure that the audited financial statements and notes will be submitted by the deadline required by State law.

GLOSSARY

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.
Education Achievement Authority (EAA)	A Michigan Statewide school system for low-performing schools.
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.
MPSERS	Michigan Public School Employees' Retirement System.
MSCI	Morgan Stanley Capital International.
MSERS	Michigan State Employees' Retirement System.
OFM	Office of Financial Management.
OPEB	other postemployment benefits.
ORS	Office of Retirement Services.
other noncompliance	Violations of contracts or grant agreements that are not material to the financial statements but should be communicated to management in accordance with *Government Auditing Standards*. Other noncompliance also

	includes violations of laws, regulations, contracts, or grant agreements; fraud; abuse; or other internal control deficiencies that may be communicated to management in accordance with *Government Auditing Standards*.
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.
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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