

Michigan Education Savings Program  
(a fiduciary fund of the State of Michigan)

Audited Financial Statements

*Year Ended September 30, 2016  
with Report of Independent Auditors*

Michigan Education Savings Program

Audited Financial Statements

Year Ended September 30, 2016

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## Report of Independent Auditors

Mr. Nick Khouri, Trustee, Michigan Education Savings Program, Michigan Department of Treasury  
Mr. Doug A. Ringler, CPA, CIA, Auditor General, State of Michigan  
Lansing, Michigan

### **Report on the Financial Statements**

We have audited the accompanying financial statements of the Michigan Education Savings Program, a fiduciary fund of the State of Michigan, as of and for the year ended September 30, 2016, and the related notes to the financial statements, which collectively comprise the Michigan Education Savings Program's basic financial statements as listed in the table of contents.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditors' Responsibility***

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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

## ***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net position of the Michigan Education Savings Program, a fiduciary fund of the State of Michigan, as of September 30, 2016, and the change in fiduciary net position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

## ***Emphasis of Matter***

As discussed in Note 1, the financial statements present only the Michigan Education Savings Program, a fiduciary fund of the State of Michigan, and do not purport to, and do not present fairly the financial position of the State of Michigan in its entirety as of September 30, 2016, and the changes in its financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

## ***Other Matters***

### ***Required Supplementary Information***

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 5 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.

### ***Other Reporting Required by Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated December 5, 2016, on our consideration of the Michigan Education Savings Program'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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Michigan Education Savings Program's internal control over financial reporting and compliance.

*Andrews Hooper Pavlik PLC*

Okemos, Michigan  
December 5, 2016

# Michigan Education Savings Program

## Management's Discussion and Analysis

September 30, 2016

This section of the Michigan Education Savings Program's (MESP or Program) financial statements presents a discussion and analysis of the Program's financial performance during the year ended September 30, 2016. MESP consists of two components, a Direct-Sold Plan managed by TIAA-CREF Tuition Financing, Inc. (TFI) and the MI 529 Advisor Plan managed by TFI for which Allianz Global Investors Distributors, LLC is the plan administrator and distributor. MESP is a fiduciary fund of the State of Michigan. Readers should consider the information presented in this section in conjunction with the Program's financial statements and notes to financial statements.

### **Financial Highlights**

The Program received approximately \$160.2 million in net contributions from account owners for the year ended September 30, 2016.

The Program earned approximately \$397.9 million from investment operations and paid out approximately \$6.6 million for operating expenses during the year ended September 30, 2016.

### **Overview of the Financial Statements**

The Program's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB).

This report consists of two parts, management's discussion and analysis (this section) and the basic financial statements. The basic financial statements are comprised of a statement of fiduciary net position, a statement of changes in fiduciary net position, and notes to financial statements that explain some of the information in the financial statements and provide more detailed information.

The statement of fiduciary net position presents information on the Program's assets and liabilities, with the difference between the two reported as net position as of September 30, 2016. This statement, along with all of the Program's financial statements, is prepared using the accrual basis of accounting. Contributions are recognized when enrollment in the Program is finalized; subsequent contributions and redemptions are recognized on the trade date; expenses and liabilities are recognized when services are provided, regardless of when cash is disbursed.

The statement of changes in fiduciary net position presents information showing how the Program's assets changed during the most recent fiscal period. Changes in net position are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenue and expenses are reported in this statement for some items that will result in cash flows in future fiscal years.

# Michigan Education Savings Program

## Management's Discussion and Analysis

September 30, 2016

The notes to financial statements provide additional information that is essential to a full understanding of the data provided in the basic financial statements.

This report presents the operating results and financial status of the Program, which the State of Michigan reports as a fiduciary fund. Fiduciary fund reporting is used to account for resources held for the benefit of parties outside the governmental entity.

### Financial Analysis

#### Net Position

The following is a condensed statement of fiduciary net position as of September 30, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
<b>Assets</b>		
Investments	\$ 4,930,856,544	\$ 4,379,524,362
Cash	190,454	105,657
Receivables	6,583,555	4,814,875
Total assets	<u>4,937,630,553</u>	<u>4,384,444,894</u>
<b>Liabilities – payables</b>	7,137,678	5,484,772
Net position	<u>\$ 4,930,492,875</u>	<u>\$ 4,378,960,122</u>

Net position represents total contributions from account owners, plus the net increase from operations, less withdrawals and expenses.

Net position increased by 12.6 percent and 3.4 percent or \$551,532,753 and \$145,267,344 for the years ended September 30, 2016 and 2015, respectively. This increase is primarily due to participant contributions to the Direct-Sold Plan and the MI 529 Advisor Plan, as well as positive economic conditions in the marketplace during the year ended September 30, 2016.

Investments in MESP are approximately 100 percent of total net position, and consist of investments in the Direct-Sold Plan and investments in the MI 529 Advisor Plan. Investments in the Direct-Sold Plan include 33 investment portfolios, including 27 age-based portfolios (9 age-based portfolios for each of 3 risk strategies – conservative, moderate, and aggressive) and 6 other investment portfolios. Each portfolio invests in varying percentages in multiple TIAA-CREF funds, or the funding agreements issued by TIAA-CREF Life Insurance Company to the Program. Investments in the MI 529 Advisor Plan include 18 portfolios, including 6 age-based portfolios and 12 other portfolios. Each portfolio invests in various mutual funds.

# Michigan Education Savings Program

## Management's Discussion and Analysis

September 30, 2016

Other assets consist of cash and receivables for securities sold, contributions, and accrued income. Liabilities consist mainly of payables for securities purchased, withdrawals, and accrued expenses.

### Changes in Net Position

The following is a condensed statement of changes in fiduciary net position for the years ended September 30, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
<b>Additions</b>		
Subscriptions	\$ 516,953,817	\$ 502,805,405
Interest and dividends	100,780,893	93,443,757
Net change in fair value of investments	297,146,941	(125,109,990)
Total additions – net	<u>914,881,651</u>	<u>471,139,172</u>
<b>Deductions</b>		
Redemptions	356,719,969	318,444,856
Operating expenses	6,628,929	7,426,972
Total deductions	<u>363,348,898</u>	<u>325,871,828</u>
<b>Change in net position</b>	551,532,753	145,267,344
<b>Net position</b> – beginning of year	<u>4,378,960,122</u>	<u>4,233,692,778</u>
<b>Net position</b> – end of year	<u>\$ 4,930,492,875</u>	<u>\$ 4,378,960,122</u>

Total additions increased by \$443.8 million, from \$471.1 to \$914.9 million. This increase is due to market appreciation, as well as an increase in subscriptions as a result of an increase in the number of account holders and an increase in interest and dividends.

Total deductions increased \$37.4 million, from \$325.9 million to \$363.3 million due to an increase in redemptions, which can be attributed to an increase in the number of account holders, offset by a decrease in operating expenses. Operating expenses decreased because of a decrease in the state administrative fee percentage charge.

# Michigan Education Savings Program

## Statement of Fiduciary Net Position

September 30, 2016

	<b>The Direct-Sold Plan</b>	<b>MI 529 Advisor Plan</b>	<b>Total</b>
<b>Assets</b>			
Cash	\$ 1,000	\$ 189,454	\$ 190,454
Investments – at fair value (Note 4)	4,491,307,623	439,548,921	4,930,856,544
Dividends and interest receivable	3,083,330	222,535	3,305,865
Receivable for securities transactions	447,663	164,253	611,916
Receivable for Program units sold	2,369,056	296,718	2,665,774
Total assets	4,497,208,672	440,421,881	4,937,630,553
 <b>Liabilities</b>			
Accrued Program management fee	170,575	178,469	349,044
Payable for securities transactions	4,696,459	576,246	5,272,705
Payable for Program units redeemed	1,179,475	100,625	1,280,100
Other liabilities	76,546	159,283	235,829
Total liabilities	6,123,055	1,014,623	7,137,678
<b>Net Position</b> – Held in trust for participant education savings program	\$ 4,491,085,617	\$ 439,407,258	\$ 4,930,492,875

*The notes to the financial statements are an integral part of this statement.*

## Michigan Education Savings Program

### Statement of Changes in Fiduciary Net Position

Year Ended September 30, 2016

	<b>The Direct-Sold Plan</b>	<b>MI 529 Advisor Plan</b>	<b>Total</b>
<b>Additions</b>			
Subscriptions	\$ 439,622,662	\$ 77,331,155	\$ 516,953,817
Investment income:			
Interest and dividends	93,969,038	6,811,855	100,780,893
Net increase in fair value of investments	274,199,107	22,947,834	297,146,941
Total investment gain	368,168,145	29,759,689	397,927,834
 Total additions	 807,790,807	 107,090,844	 914,881,651
<b>Deductions</b>			
Redemptions	325,718,319	31,001,650	356,719,969
Operating expenses	2,781,851	3,847,078	6,628,929
Total deductions	328,500,170	34,848,728	363,348,898
 <b>Change in net position</b>	 479,290,637	 72,242,116	 551,532,753
<b>Net position</b> – beginning of year	4,011,794,980	367,165,142	4,378,960,122
<b>Net position</b> – end of year	\$ 4,491,085,617	\$ 439,407,258	\$ 4,930,492,875

*The notes to the financial statements are an integral part of this statement.*

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### **1. Organization**

The Michigan Education Savings Program (Program), a fiduciary fund of the State of Michigan, is designed to help people save for the costs of higher education. The Program was established by the Michigan Department of Treasury and is administered by the State Treasurer of Michigan (Treasurer), who acts as trustee of the Program. The Program constitutes a qualified tuition program under Section 529 of the Internal Revenue Code and was established pursuant to Section 529 and the Michigan Compiled Laws 390.1471 et seq. The Program consists of two components, the Direct-Sold Plan and the MI 529 Advisor Plan. Investment portfolios and allocations, as approved by the Treasurer, are described in the current disclosure booklet for each respective component. The Treasurer has the authority to enter into contracts for program management services, appoint a program manager, adopt policies and operating procedures to implement and administer the Program, and establish investment policies for the Program.

TIAA-CREF Tuition Financing, Inc. (TFI), a wholly-owned, indirect subsidiary of Teachers Insurance and Annuity Association of America (TIAA), manages the Direct-Sold Plan under the direction of the Treasurer pursuant to a contract that it has entered into with the State of Michigan. The assets in the Principal Plus Interest Option and certain other investment portfolios are allocated to funding agreements issued by TIAA-CREF Life Insurance Company (TIAA Life), an affiliate of TFI. The funding agreements guarantee to the Michigan Department of Treasury a minimum rate of interest and provide the opportunity for additional interest as declared periodically by TIAA Life. Teachers Advisors, Inc. (Advisors), an affiliate of TFI, is registered with the Securities and Exchange Commission as an investment advisor and provides investment advisory services to the TIAA-CREF funds. As of December 31, 2015, TIAA-CREF Individual & Institutional Services, LLC provides underwriting and distributing services to the Direct-Sold Plan.

The MI 529 Advisor Plan component of the Michigan Education Savings Program was established under Public Act (PA) No. 161 of 2000 of the State of Michigan, which was amended by PA No. 153 of 2007. TFI acts as the program manager for the MI 529 Advisor Plan. TFI, per the State's approval, has delegated the responsibilities of being the administrator and distributor to Allianz Global Investors Distributors, LLC (AGID). AGID provides services to the MI 529 Advisor Plan including administration, distribution, and investment management services. AGID has delegated the investment-related functions for the MI 529 Advisor Plan to Allianz Global Investors U.S. LLC (AGI U.S.), an affiliate of AGID, including making recommendations to the Treasurer as to the formulation of the investment portfolios and the selection of the underlying funds and asset allocations among such funds.

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### **2. Significant Accounting Policies**

The accompanying financial statements were prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB), which may require the use of estimates made by management. Actual results may differ from those estimates. The following is a summary of the significant accounting policies consistently followed by the Program.

#### **Valuation of Investments**

The market value of the investments in the underlying mutual funds is based on the net asset values of the respective classes of the mutual funds on the close of business on the valuation date. The value of the TIAA Life funding agreements (within the Direct-Sold Plan), to which the Principal Plus Interest Option and certain other investment portfolios allocate assets, is stated at cost, which approximates fair value. The TIAA Life funding agreements have a floating rate of interest that resets annually based on a projected rate of return.

#### **Units**

The beneficial interest for each account owner in the investment portfolios is represented by Program units. Subscriptions and redemptions are recorded upon receipt of the account owner's instructions in good order, based on the next determined daily net asset value per unit (Unit Value). Unit Values for each investment portfolio are determined at the close of business of the New York Stock Exchange.

#### **Investment Transactions**

Portfolio transactions, normally in shares of the underlying funds, are accounted for as of the trade date. Realized gains and losses are determined on the identified cost basis.

#### **Withdrawals**

The earnings portions of nonqualified and penalty-free withdrawals are taxable to the account owner or the beneficiary. Earnings portions of nonqualified withdrawals also may be subject to a federal penalty tax.

#### **Distributions**

All net investment income and net realized gains of the portfolios will be reinvested in the portfolios; distributions will not be declared.

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### **2. Significant Accounting Policies (continued)**

#### **Investment Income**

Dividend income and capital gain distributions from the underlying funds, if any, are recorded on the ex-dividend date. Capital gain distributions, if any, from underlying funds are a component of the net increase in the fair value of investments. Interest income is recorded as earned.

#### **Income Taxes**

The Program is exempt from federal income tax under Section 529 of the Internal Revenue Code of 1986 and does not expect to have any unrelated business income subject to tax. Accordingly, no provision for federal income taxes has been made.

### **3. Management Agreements**

A separate management agreement exists for the Direct-Sold Plan and the MI 529 Advisor Plan.

#### **Direct-Sold Plan**

During the fiscal year, for its services as program manager of the Direct-Sold Plan, with respect to all investment portfolios (other than the Principal Plus Interest Option), TFI is paid an annual program management fee of 0.05% of the average daily net position of the Direct-Sold Plan invested in such portfolios. In addition, Advisors is paid investment management fees on the underlying investments in the TIAA-CREF funds.

For its services related to administering the Direct-Sold Plan, each investment portfolio (with the exception of the Principal Plus Interest Option) pays to the Michigan Department of Treasury an administrative fee at an annual rate of 0.02% of the average daily net position held by that portfolio.

The Principal Plus Interest Option does not pay a fee to the program manager or to the Michigan Department of Treasury. TIAA Life, the issuer of the funding agreements in which this portfolio invests and an affiliate of TFI, makes payments to TFI. TIAA Life also pays the Michigan Department of Treasury a fee equal to 0.02% of the average daily net position held by the Principal Plus Interest Option.

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### 3. Management Agreements (continued)

#### MI 529 Advisor Plan

The State of Michigan has entered into a program management agreement with TFI, which has subcontracted with AGID to provide administrative, recordkeeping, marketing, and investment management services to the MI 529 Advisor Plan. Account owners bear expenses at the investment portfolio level and also indirectly bear the expenses in the underlying funds.

The MI 529 Advisor Plan compensates AGID for services provided and expenses incurred in connection with sales of units and services rendered to unit-holders and for maintenance of unit-holder accounts of A and C units. The MI 529 Advisor Plan paid AGID distribution and servicing and administrative fees at an effective annual rate as set forth below (calculated as a percentage of each portfolio's average daily net position attributable to each class):

	<u>Class A Units</u>	<u>Class C Units</u>
Program management fee <sup>1</sup>	0.50%	0.50%
Servicing and administrative fee:		
PIMCO Short Asset Investment Portfolio	0.10%	0.10%
Other portfolios	0.25%	0.08%, 0.15% <sup>3</sup>
Distribution fee:		
PIMCO Short Asset Investment Portfolio	None	None
Other portfolios	None	0.25%, 0.50% <sup>2</sup>
State administration fee <sup>4</sup>	0.05%	0.05%

<sup>1</sup> A portion of the program management fee is paid by AGID to the program manager monthly.

<sup>2</sup> The Age-Based and Static Investment Portfolios are assessed a distribution fee of 0.50 percent. The individual Investment Portfolios are assessed a distribution fee of 0.25 percent.

<sup>3</sup> The Age-Based and Static Investment Portfolios are assessed a servicing and administrative fee of 0.15 percent. The individual Investment Portfolios are assessed a servicing and administrative fee of 0.08 percent.

<sup>4</sup> Paid directly to the State of Michigan to administer and maintain the State of Michigan's qualified tuition programs.

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### **3. Management Agreements (continued)**

#### **MI 529 Advisor Plan (continued)**

AGID also receives the proceeds of the initial sales charge paid by the unit-holders upon the purchase of A units and the contingent deferred sales charges (CDSC) paid by unit-holders upon certain redemptions of C units as described in detail in the prevailing plan disclosure statement. Units of PIMCO Short Asset Investment Portfolio are not subject to initial sales charges or CDSC.

For the year ended September 30, 2016, AGID received approximately \$226,000 in initial sales charges and \$11,000 in CDSC. All or a substantial portion of the sales charges paid by the investor may be paid to the selling financial intermediary through which the account owners make their investments.

### **4. Investments**

Investments in the Direct-Sold Plan include 33 investment portfolios, including 27 age-based portfolios (9 age-based portfolios for each of 3 risk strategies – conservative, moderate, and aggressive) and 6 other investment portfolios. Each portfolio invests in varying percentages in multiple TIAA-CREF funds, or the funding agreements issued by TIAA Life to the Program. Investments in the MI 529 Advisor Plan include 18 portfolios, including 6 age-based portfolios and 12 other portfolios. Each portfolio invests in various mutual funds.

#### **Cash Deposits**

Cash deposits were reflected in the accounts of the bank (without recognition of checks written, but not yet cleared, or of deposits in transit). As of September 30, 2016, the Program's bank balance was \$190,454 with an insured amount of \$190,454.

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### 4. Investments (continued)

As of September 30, 2016 the Program's investments consisted of the following:

	<u>Cost</u>	<u>Market Value</u>
The Direct-Sold Plan:		
TIAA-CREF Funds (Institutional Class):		
Bond Index Fund	\$ 1,050,231,449	\$ 1,077,643,627
Emerging Markets Equity Index Fund	102,324,372	102,372,512
Equity Index Fund	1,041,200,210	1,530,821,098
High-Yield Fund	149,740,753	149,333,198
Inflation-Linked Bond Fund	305,488,705	305,406,729
International Equity Index Fund	463,746,813	513,567,711
TIAA-CREF Life Insurance Company:		
Funding agreements	644,630,036	644,630,036
Vanguard REIT Index Fund	146,998,580	167,532,712
Subtotal	3,904,360,918	4,491,307,623
MI 529 Advisor Plan:		
AllianzGI Best Styles Global Equity Fund	95,673,138	101,525,960
AllianzGI Best Styles International Equity Fund	8,920,528	9,099,474
AllianzGI Best Styles U.S. Equity Fund	7,678,690	8,300,021
AllianzGI Income & Growth Fund	11,847,210	10,982,460
AllianzGI Global Allocation Fund	101,302,281	103,346,430
AllianzGI Global Small-Cap Fund	6,750,004	6,951,893
AllianzGI Short Duration High Income Fund	10,898,388	10,874,969
PIMCO CommodityRealReturn Strategy Fund	11,634,770	11,559,217
PIMCO Income Fund	19,131,378	18,960,912
PIMCO RealEstateRealReturn Strategy Fund	10,359,092	10,568,276
PIMCO Real Return Fund	30,858,790	31,931,965
PIMCO Short Asset Investment Fund	41,068,655	41,111,815
PIMCO Total Return Fund	12,859,176	12,285,807
TIAA-CREF Bond Index Fund	20,389,990	20,897,316
TIAA-CREF Small-Cap Blend Index Fund	8,508,976	9,146,326
TIAA-CREF S&P 500 Index Fund	28,498,399	32,006,080
Subtotal	426,379,465	439,548,921
Total	<u>\$ 4,330,740,383</u>	<u>\$ 4,930,856,544</u>

All of the investments above, except the Vanguard REIT Index Fund, are related party transactions.

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### **4. Investments (continued)**

An account owner has an investment in an investment portfolio and not a direct investment in any underlying mutual fund or other investment vehicle to which funds in that investment portfolio may be allocated.

Certain investments are subject to a variety of investment risks based on the amount of risk in the underlying funds. GASB requires that entities disclose certain essential risk information about deposits and investments. All of the Program's investment portfolios are uninsured and unregistered and are held by a custodian in the Program's name.

The mutual funds in which the portfolios invest are comprised of various investment securities, which include corporate debt and equity securities, obligations of the United States government and government agencies, and international equity securities. Certain underlying funds may invest in certain specified derivative securities, including interest rate and credit default swaps; caps and floors for hedging purposes; exchange-traded options; and over-the-counter options executed with primary dealers, including long calls and puts and covered calls and financial futures and options. Certain underlying funds may invest in restricted securities including: instruments issued by trusts, partnerships, or other issuers, including pass-through certificates representing participations in, or debt instruments backed by, the securities owned by such issuers. These underlying funds also may engage in securities lending, reverse repurchase agreements, and dollar roll transactions. In addition, certain underlying funds may invest in mortgage-backed securities, structured investment vehicles, below-investment grade debt, debt obligations of foreign issuers and stocks of foreign corporations, securities in foreign investment funds or trusts, foreign derivative securities including futures contracts, options, interest rate and currency swap transactions, and various other investment vehicles, each with inherent risks, including market, credit, interest rate, foreign currency leverage, and liquidity risks. Due to the level of risk associated with these investment securities, it is at least reasonably possible that changes in their fair values may occur in the near term and that such changes could materially affect account owner balances and the amounts reported in the Program's financial statements.

### **Custodial Credit Risk**

Custodial credit risk is the risk that in the event of a failure, the Program's deposits and investments may not be returned. The Program does not have formal custodial credit risk policies for investments. An account owner has an investment in an investment portfolio and not a direct investment in any underlying mutual fund or other investment vehicle to which funds in that investment portfolio may be allocated. Because of this ownership structure, the custodial credit risk is significantly mitigated.

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### 4. Investments (continued)

#### Credit Risk

The underlying funds invested primarily in fixed-income securities are subject to credit risk. Credit risk is the potential of failure of the other party to pay interest and principal when due as a result of adverse market or economic conditions. The Program does not have formal investment policies for managing credit risk. The underlying mutual funds do not carry a formal credit quality rating. The underlying funding agreements, to which the Principal Plus Interest Option and certain other portfolios of the Direct-Sold Plan allocate assets, are guaranteed insurance products issued by TIAA Life. TIAA Life has a Standard & Poor's credit rating of AA+ as of September 30, 2016.

#### 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 Program does not have a formal investment policy that limits maturities as a means of managing its exposure to fair value losses arising from increasing interest rates. As of September 30, 2016, the average maturities for the underlying fixed-income mutual funds are as follows:

	<u>Market Value</u>	<u>Average Maturity</u>
The Direct-Sold Plan:		
TIAA-CREF Funds (Institutional Class):		
Bond Index Fund	\$ 1,077,643,627	7.52 years
High-Yield Fund	149,333,198	7.90 years
Inflation-Linked Bond Fund	305,406,729	5.82 years
MI 529 Advisor Plan:		
AllianzGI Short Duration High Income Fund	10,874,969	3.29 years
PIMCO CommodityRealReturn Strategy Fund	11,559,217	3.08 years
PIMCO Income Fund	18,960,912	4.75 years
PIMCO RealEstateRealReturn Strategy Fund	10,568,276	6.37 years
PIMCO Real Return Fund	31,931,965	8.77 years
PIMCO Short Asset Investment Fund	41,111,815	0.00 years
PIMCO Total Return Fund	12,285,807	8.18 years
TIAA-CREF Bond Index Fund	20,897,316	7.52 years

# Michigan Education Savings Program

## Notes to Financial Statements

September 30, 2016

### 4. Investments (continued)

#### Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of investments in foreign securities. The Program does not have formal foreign currency risk policies for investments. Certain investment portfolios allocate assets to underlying mutual funds that are exposed to foreign currency risk. The Program does not have any direct investment in foreign fixed-income securities. As of September 30, 2016, the values of investments in underlying mutual funds that primarily invest in foreign securities are as follows:

	<u>Market Value</u>
The Direct-Sold Plan:	
TIAA-CREF Funds (Institutional Class):	
Emerging Markets Equity Index Fund	\$ 102,372,512
International Equity Index Fund	513,567,711
MI 529 Advisor Plan:	
AllianzGI Best Styles International Equity Fund	9,099,474
AllianzGI Best Styles Global Equity Fund	101,525,960
AllianzGI Global Small-Cap Fund	6,951,893
AllianzGI Global Allocation Fund	103,346,430

### 5. Fair Value Measurements

The Program categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

In instances whereby inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Program's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

The Program has the following recurring fair value measurements as of September 30, 2016:

- Investments in registered investment companies totaling \$4,286,226,508 as of September 30, 2016 are valued at their net asset value on the valuation date based on quoted prices in active markets (Level 1 inputs).

The TIAA Life funding agreements in the Direct-Sold Plan valued at \$644,630,036 as of September 30, 2016 are considered nonparticipating interest-earning investment contracts and are accounted for at cost.

Independent Auditors' Report on Internal Control Over Financial Reporting and on  
Compliance and Other Matters Based on an Audit of Financial Statements Performed in  
Accordance with *Government Auditing Standards*

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Compliance and Other Matters Based on an Audit of Financial Statements  
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Mr. Nick Khouri, Trustee, Michigan Education Savings Program, Michigan Department of Treasury  
Mr. Doug A. Ringler, CPA, CIA, Auditor General, State of Michigan  
Lansing, Michigan

We have audited, 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, the financial statements of the Michigan Education Savings Program (Program), a fiduciary fund of the State of Michigan, as of and for the year ended September 30, 2016, and the related notes to the financial statements, which collectively comprise the Program's basic financial statements, and have issued our report thereon dated December 5, 2016.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the Program's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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 Program's internal control. Accordingly, we do not express an opinion on the effectiveness of the Program's internal control.

*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. *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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

## **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Michigan Education Savings Program'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*.

## **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of our testing, and not to provide an opinion on the effectiveness of the Program's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Program's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

*Andrews Hooper Pavlik PLC*

Okemos, Michigan  
December 5, 2016