INTRODUCTION

The following discussion and analysis provides an overview of the financial position of the University of Michigan (the "University") at June 30, 2007 and 2006 and its activities for the three fiscal years ended June 30, 2007. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

The University is a comprehensive public institution of higher learning with approximately 55,000 students and 6,400 faculty members on three campuses in southeast Michigan. The University offers a diverse range of degree programs from baccalaureate to post-doctoral levels through 19 schools, colleges and divisions, and contributes to the state and nation through related research and public service programs. The University, in total, employs more than 48,000 permanent and temporary staff. The University also maintains one of the largest health care complexes in the world through its Hospitals and Health Centers ("HHC"). HHC consists of three hospitals, 30 health centers and more than 120 outpatient clinics. HHC is an integral part of the University's Health System which also includes the University's Medical School; Michigan Health Corporation, a wholly-owned corporation created to pursue joint venture and managed care initiatives; and M-CARE, a wholly-owned health maintenance organization which was sold effective December 31, 2006.

The University consistently ranks among the nation's top universities by various measures of quality, both in general academic terms, and in terms of strength of offerings in specific academic disciplines and professional subjects. Excellence in research is another crucial element in the University's high ranking among educational institutions. Research is central to the University's mission and permeates its schools and colleges. In addition to the large volume of research conducted within the academic schools, colleges, and departments, the University has more than a dozen large-scale research institutes outside the academic units that conduct, in collaboration with those units, full-time research focused on long-term interdisciplinary matters. The University's Health System also has a tradition of excellence in teaching, advancement of medical science and patient care, consistently ranking among the best health care systems in the nation.

FINANCIAL HIGHLIGHTS

The University's financial position remains strong, with assets of $13.8 billion and liabilities of $2.3 billion at June 30, 2007, compared to assets of $12.0 billion and liabilities of $2.1 billion at June 30, 2006. Net assets, which represent the residual interest in the University's assets after liabilities are deducted, increased $1.6 billion in fiscal 2007, to $11.5 billion at June 30, 2007. Changes in net assets represent the University's results of operations and are summarized for the years ended June 30, 2007 and 2006 as follows:

(in millions)	**2007**	2006
Operating revenues and state educational appropriations	**$ 4,167.8**	$ 4,147.9
Total expenses	**4,464.2**	4,283.1
	(296.4)	(135.2)
Net investment income	**1,572.6**	959.8
Gifts and other nonoperating revenues, net	**336.8**	249.2
Increase in net assets	**$ 1,613.0**	$ 1,073.8

Net assets increased $1.6 billion in 2007 and $1.1 billion in 2006 primarily due to net investment income of $1.6 billion and $960 million in 2007 and 2006, respectively. The results of operations reflect the University's focus on maintaining its national standards academically, and in research and health care, while addressing declining state appropriations and rising health care, regulatory, and facility costs in a competitive recruitment environment for faculty and health care professionals. The results of operations also reflect the sale of M-CARE effective December 31, 2006. Operating revenues and state educational appropriations increased 0.5 percent, or $20 million, while total expenses increased 4 percent, or $181 million. Gifts and other nonoperating revenues increased 35 percent to $337 million, which includes a $160 million gain on the sale of M-CARE.

The University invests its financial assets to maximize total return with an appropriate level of risk.While the University's working capital is invested in relatively short duration assets, the University invests its endowment with a strategy that seeks to maximize total return over the long term. The success of this long-term investment strategy is evidenced by strong returns over sustained periods of time and the University's ability to limit losses in the face of challenging markets.

SALE OF M-CARE

Formed by the University in 1986, M-CARE offered managed health care benefits to the employees of the University and other employers in Southeast Michigan. Completing the sale of M-CARE to Blue Cross Blue Shield of Michigan ("Blue Cross") and its subsidiary Blue Care Network in fiscal 2007 enabled the University to make a smooth transition with a non-profit, community-minded, quality-oriented partner, at a time when the health insurance industry is experiencing great turbulence, including the rapid growth of consumer driven health care plans and emerging technologies that require significant capital investment. This sale enables the University to better direct its resources toward its core mission of education, research and patient care. Subscription premiums revenue recognized by M-CARE from employers other than the University totaled approximately $197 million and $405 million for the six months ended December 31, 2006 and the year ended June 30, 2006, respectively.

Proceeds from the sale, net of expenses, totaled $258 million and the University recognized a $160 million gain on the sale in fiscal 2007. The purchase price will be adjusted based on certain changes in net assets pursuant to terms of the sales agreement; however, such amount is not expected to be material. As part of the sale, Blue Cross also committed up to $10 million to launch a joint venture with the University. This venture will commission research and other projects aimed at improving the quality of health care in the state of Michigan, and transforming the way patient care is delivered in the state and beyond.

University members enrolled in M-CARE at the time of the sale will maintain the same coverage through December 31, 2007. Replacement health plans designed and funded by the University, similar to the current M-CARE HMO and GradCare plans, will be available for calendar 2008 in addition to the other health plan choices offered by the University. The replacement plans will be offered only to the University community and administered by Blue Cross.

USING THE FINANCIAL STATEMENTS

The University's financial report includes three financial statements: the Statement of Net Assets; the Statement of Revenues, Expenses and Changes in Net Assets; and the Statement of Cash Flows. These financial statements are prepared in accordance with Governmental Accounting Standards Board ("GASB") principles, which establish standards for external financial reporting for public colleges and universities and require that financial statements be presented on a consolidated basis to focus on the University as a whole.

STATEMENT OF NET ASSETS

The statement of net assets presents the financial position of the University at the end of the fiscal year and includes all assets and liabilities of the University. The difference between total assets and total liabilities—net assets—is one indicator of the current financial condition of the University, while the change in net assets is an indicator of whether the overall financial condition has improved or worsened during the year. Assets and liabilities are generally measured using current values. One notable exception is capital assets, which are stated at historical cost less an allowance for depreciation. A comparison of the University's assets, liabilities and net assets at June 30, 2007 and 2006 is summarized as follows:

(in millions)	**2007**	2006
Current assets	**$ 2,431**	$ 2,337
Noncurrent assets:		
Endowment, life income and other investments	**7,380**	5,963
Capital assets, net	**3,755**	3,453
Other	**263**	245
Total assets	**13,829**	11,998
Current liabilities	**892**	913
Noncurrent liabilities	**1,440**	1,201
Total liabilities	**2,332**	2,114
Net assets	**$ 11,497**	$ 9,884

The University continues to maintain and protect its strong financial foundation. This financial health, as reflected in the statement of net assets at June 30, 2007 and 2006, results from the prudent utilization of financial resources including careful cost controls, preservation of endowment funds, conservative utilization of debt, and adherence to a long-range capital plan for the maintenance and replacement of the physical plant.

Current assets consist primarily of cash and cash equivalents, operating and capital investments, and accounts receivable. Total current assets increased $94 million, to $2.4 billion at June 30, 2007. Cash and cash equivalents and operating investments totaled $1.2 billion at June 30, 2007, which represents approximately three months of total expenses excluding depreciation.

Current liabilities consist primarily of accrued compensation, accounts payable, deferred revenue, commercial paper and the current portion of bonds payable. Total current liabilities decreased $21 million, to $892 million at June 30, 2007, primarily due to a decrease in investment trade settlements payable.

ENDOWMENT, LIFE INCOME AND OTHER INVESTMENTS

The University's endowment, life income and other investments increased $1.4 billion, to $7.4 billion at June 30, 2007. This increase primarily resulted from favorable investment performance and the receipt of new endowment funds through gifts and transfers, offset by endowment distributions to beneficiary units for operations. The composition of the University's endowment, life income and other investments at June 30, 2007 and 2006 is summarized as follows:

(in millions)	**2007**	2006
Endowment investments	**$ 7,090**	$ 5,652
Life income investments	**120**	101
Noncurrent portion of insurance and benefits obligations and managed care investments	**170**	210
	$ 7,380	$ 5,963

The University's endowment funds consist of both permanent endowments and funds functioning as endowment. Permanent endowments are those funds received from donors with the stipulation that the principal remain inviolate and be invested in perpetuity to produce income that is to be expended for the purposes specified by the donors. Funds functioning as endowment consist of amounts (restricted gifts or unrestricted funds) that have been allocated by the University for long-term investment purposes, but are not limited by donor stipulations requiring the University to preserve principal in perpetuity. Programs supported by endowment funds include scholarships, fellowships, professorships, research efforts, and other important programs and activities.

The University uses its endowment funds to support operations in a way that strikes a balance between generating a predictable stream of annual support for current needs and preserving the purchasing power of the endowment funds for future periods. The major portion of the endowment is maintained in the University Endowment Fund, which is invested in the University's Long Term Portfolio, a single diversified investment pool. The University's endowment spending rate policy provides for an annual distribution of 5 percent of the one-quarter lagged, moving average fair value of University Endowment Fund assets, with distributions limited to 5.3 percent of current fair value.

Any capital gains or income generated above the spending rate are reinvested so that in lean times funds will be available. Because the spending rate is based on a multiple year moving average fair value, the percent distributed for operating purposes is different when stated in the context of current fair value. Actual distributions were 3.8 percent, 4.1 percent and 4.2 percent of the fair value of the endowment at June 30, 2007, 2006 and 2005, respectively. Effective July 1, 2006, the moving average period was extended from three years to four years and it is being extended by one quarter each subsequent quarter until it reaches seven years. This change is expected to reduce distribution volatility, as well as better preserve and grow the endowment corpus over time.

CAPITAL AND DEBT ACTIVITIES

One of the critical factors in continuing the quality of the University's academic, research and clinical programs is the development and renewal of capital assets. The University continues to implement its long-range plan to modernize its complement of older facilities, along with balanced investment in new construction.

Capital asset additions totaled $611 million in 2007, as compared to $616 million in 2006. Capital asset additions primarily represent replacement, renovation and new construction of academic, research and clinical facilities, as well as significant investments in equipment, including information technology. Current year capital asset additions were primarily funded with gifts and net assets designated for capital purposes of $403 million, as well as debt proceeds of $202 million and state capital appropriations of $6 million. Construction in progress, which totaled $349 million at June 30, 2007 and $557 million at June 30, 2006, includes important new facilities for patient care, research, instruction and student residential life.

Construction projects completed in 2007 include new buildings for the Cardiovascular Center and the Gerald R. Ford School of Public Policy. The Cardiovascular Center facility is one of the nation's first fully comprehensive cardiovascular treatment centers, with operating rooms, patient rooms, clinics, classrooms and laboratories. In addition to giving cardiovascular patients an all-in-one location for their care, this new clinical building will help meet the surging demand for cardiovascular services and bring together specialized services and facilities that are now located throughout the University's Health System. This state-of-the-art facility, whose construction commenced in 2003, is located just south of the University Hospital. To provide parking for patients and staff, a 465-space parking structure was also constructed as part of this project.

Joan and Sanford Weill Hall houses the Gerald R. Ford School of Public Policy and serves as the southern gateway to the Central Campus. Located at State and Hill streets, this new building enabled the consolidation of three Ford School campus locations into a single facility with classrooms, a library, research centers, a computer laboratory, faculty offices and public spaces for conferences and lectures. With its new space, the Ford School is adding an undergraduate major, growing its faculty, and expanding the scope of its educational programming.

Renovation and expansion projects completed in 2007 include the School of Public Health facilities. This project provided modernization of building systems and additional space, through replacement of the east-west wing of the Henry F. Vaughan Public Health Building with modern laboratories, classrooms, conference rooms and community focused research space. The facility's innovative design and state-of-the-art technology better enable faculty and students to address today's top public health priorities, including new genetic technologies, the financing of health care, the globalization of health, public health preparedness and the prevention and treatment of infectious disease. The addition also connects to the Thomas Francis Jr. Building to form one public health complex which serves as a crossroads of activity, from research and teaching to academe and community.

At June 30, 2007, many significant facility enhancement projects are underway for critical academic, patient care, research and residential life facilities. Business education has undergone a fundamental change from lecture-style classes to interactive methods that integrate individual preparation, teamwork and in-class discussion, while effectively utilizing advanced technology. Construction is in progress on a new facility for the Stephen M. Ross School of Business which will support the School's distinct, team-based learning that bridges theory and practice. Classrooms, offices and other spaces will be arranged in a setting conducive to collaboration inside the school. Technology designed into the building will foster interaction with firms and organizations around the world. In order to make way for the new structure, Davidson Hall, Paton Accounting Center, Assembly Hall and an electrical switching station were demolished. The University expects this new facility to be completed in Fall 2008.

C.S. Mott Children's and Women's Replacement Hospitals are being constructed to meet increasing patient demand and accommodate future research, education and clinical care innovations. The new state-of-the art facility for these hospitals will further enhance specialty services for newborns, children and pregnant women not offered anywhere else in Michigan, including programs for Level I pediatric trauma, pediatric liver transplant, and craniofacial anomalies as well as high-risk pregnancy and specialty gynecological services. With a clinic building of nine floors and an inpatient building of twelve floors, the new facility will be approximately 1.1 million gross square feet. After the new facility for the replacement hospitals is completed in 2011, the facility housing the existing C.S. Mott Children's and Women's hospitals will be used to benefit the entire Health System.

During 2007, the University broke ground on a new state-of-the art eye center that will more than double capacity for eye care, research and education, as well as give scientists more space to search for a cure for Type 1 diabetes. The new facility, which includes eight floors for clinics, surgery and research, will serve the growing number of patients who need advanced eye care and access to the latest research discoveries. Large windows and a full wall of glass panels on the building's façade will allow natural light to fill the clinics and common space, of particular benefit to patients whose vision is impaired. Clinics will have space for patient education and comfortable waiting areas designed to aid patient flow. Research areas will feature open laboratories to encourage collaboration and provide flexibility as research projects grow. The new facility will also house the Brehm Center for Type 1 Diabetes Research and Analysis, which will provide opportunities for collaboration among diabetes and vision scientists, particularly on vision loss caused by diabetes. The new eye center, which is expected to open in 2010, will be adjacent to and connected to the current Kellogg Eye Center tower.

The University also began construction of its first new student residence hall in more than 40 years. Combining sophisticated classroom and academic space with residence space for 460 students, the North Quad Residential and Academic Complex will provide classrooms, studios and offices for five information and communications-related university programs. The result will be an environment in which interactions among students and faculty flow from classrooms to hallways to faculty offices to living quarters. The living spaces, like the whole of the project, are designed to facilitate student learning, and student social and programmatic needs. The University expects this new facility to be completed in Summer 2010.

Mosher-Jordan is the University's first residence hall to undergo a comprehensive renewal and renovation. This project, which continued in 2007, is preserving the existing historic areas and details, while creating new community environments by reconfiguring current spaces and completing significant infrastructure upgrades. The project also includes a new, multi-level lobby and entrance to provide a single point of entry for residents and visitors, as well as centralized services for students in both houses of Mosher-Jordan. Infrastructure upgrades include new plumbing, elevators, heating, ventilation, fire detection and suppression systems, wired and wireless high-speed network access, renovated bath facilities, and accessibility improvements. Taking place along with this renovation is the creation of Hill Dining Center which will enable the University to consolidate dining services for all of the Hill area residence halls. This innovative new dining center will be attached to Mosher-Jordan on the rear of the building facing Palmer Field and will feature a marketplace style facility with seating for 700 as well as a food emporium on the top floor with café style seating for 70. The University expects this project to be completed in Fall 2008.

The Museum of Art's historic home, Alumni Memorial Hall, is undergoing a transformative facility expansion and restoration. An addition will nearly double the Hall's size to address space needs and allow for future growth in collections and programming, while the renovation will address needed infrastructure improvements. The addition consists of three floors with a lower level and will provide space for galleries, collections, exhibitions, classrooms, and administration. The University expects this project to be completed in Summer 2008.

An expansion and renovation of the Solid State Electronics Laboratory in the Electrical Engineering and Computer Science Building is also underway. The laboratory facility, which was established in 1986, is in need of infrastructure updates and additional space for testing and prototype development. This project will provide a new clean room and support space as well as architectural, mechanical and electrical improvements. The renovation and expansion of this facility, which has been renamed the Michigan Nanofabrication Facility, will result in one of the premier nanofabrication facilities in the world and support important new energy initiatives, nanotechnology, microchip fabrication and other research initiatives. The University expects this project to be completed in December 2007.

The University takes seriously its financial stewardship responsibility and works hard to manage its financial resources effectively, including the prudent use of debt to finance capital projects. A strong debt rating is an important indicator of the University's success in this area. During 2007, Moody's Investors Service affirmed its highest credit rating (Aaa) for bonds backed by a broad revenue pledge based on the University's extremely strong credit fundamentals, including significant financial resources, strong market position and consistent operating performance derived from a well diversified revenue base. Standard & Poor's Ratings Services also affirmed its highest credit rating (AAA) based on the University's national reputation for excellence, strong financial performance, exceptional record of fundraising, and manageable debt burden and capital plan. Only two other public universities have received the highest credit ratings from both Moody's and Standard & Poor's.

Long-term debt activity for the year ended June 30, 2007, and the type of revenue it is supported by, is summarized as follows:

(in millions)	Beginning Balance	Additions	Reductions	Ending Balance
Commercial Paper:				
General revenues	$ 97	$ 52	$ 39	$ 110
Bonds and Notes:				
General revenues	266		11	255
Hospital revenues	442	150	11	581
Faculty Group Practice revenues	96	1	3	94
Student residences revenues	14		12	2
Student fee revenues	3		3	–
	$ 918	$ 203	$ 79	$ 1,042

The University maintains a combination of fixed and variable rate debt with effective interest rates that averaged 4.04 percent in 2007 and 3.75 percent in 2006. Consistent with the University's capital and debt financing plans, total outstanding debt increased $124 million, or 14 percent, to $1.0 billion at June 30, 2007, and interest expense increased 13 percent, to $31 million.

The University utilizes commercial paper, backed by a general revenue pledge, to provide interim financing for its capital improvement program. Outstanding commercial paper is converted to long-term debt financing, as appropriate, within the normal course of business. At June 30, 2007 and 2006, commercial paper totaled $110 million and $97 million, respectively, and is included in current liabilities.

In April 2007, the University issued $150 million in variable rate hospital revenue bonds to provide $126 million in funds for health system capital projects, including the replacement C.S. Mott Children's and Women's Hospitals, and to convert $24 million of commercial paper to long-term debt. In May 2007, the University entered into a floating-to-fixed interest rate swap agreement for a notional amount tied to a portion of the outstanding balance of the Series 2002 General Revenue Bonds, which totaled $58 million at June 30, 2007. The swap agreement converts the floating variable rate on these bonds, which was 3.73 percent at June 30, 2007, to a fixed rate of 3.54 percent commencing June 2007 through April 2018.

NET ASSETS

Net assets represent the residual interest in the University's assets after liabilities are deducted. The composition of the University's net assets at June 30, 2007 and 2006 is summarized as follows:

(in millions)	**2007**	2006
Invested in capital assets, net of related debt	**$ 2,864**	$ 2,615
Restricted:		
Nonexpendable:		
Permanent endowment corpus	**960**	884
Expendable:		
Net appreciation of permanent endowments	**1,420**	1,022
Funds functioning as endowment	**1,492**	1,190
Restricted for operations and other	**693**	563
Unrestricted	**4,068**	3,610
	$ 11,497	$ 9,884

Net assets invested in capital assets represent the University's capital assets net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets. The $249 million increase reflects the University's continued development and renewal of its capital assets in accordance with its long-range capital plan.

Restricted nonexpendable net assets represent the historical value (corpus) of gifts to the University's permanent endowment funds. The $76 million increase primarily represents new gifts. Restricted expendable net assets are subject to externally imposed stipulations governing their use. This category of net assets includes net appreciation of permanent endowments, funds functioning as endowment and net assets restricted for operations, facilities and student loan programs. Restricted expendable net assets totaled $3.6 billion at June 30, 2007, as compared to $2.8 billion at June 30, 2006.

Although unrestricted net assets are not subject to externally imposed stipulations, all of the University's unrestricted net assets have been designated for various academic and research programs and initiatives, as well as capital projects. In addition, unrestricted net assets include funds functioning as endowment of $3.1 billion and $2.4 billion at June 30, 2007 and 2006, respectively.

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

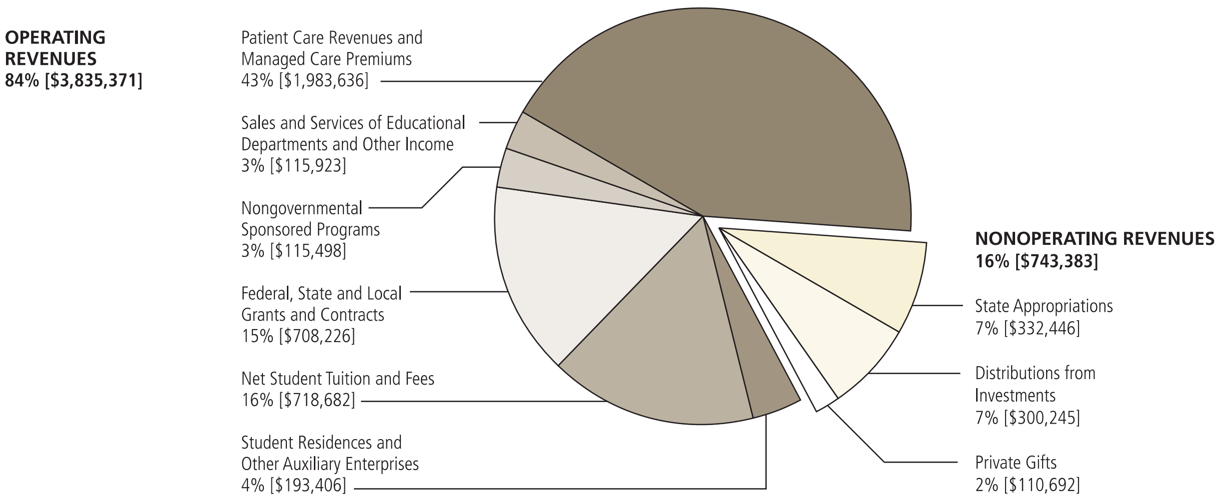
The statement of revenues, expenses and changes in net assets presents the University's results of operations. In accordance with GASB reporting principles, revenues and expenses are classified as either operating or nonoperating. A comparison of the University's revenues, expenses and changes in net assets for the three years ended June 30, 2007 is summarized as follows:

(in millions)	**2007**	2006	2005
Operating revenues:			
Student tuition and fees, net of scholarship allowances	**$ 718.7**	$ 675.7	$ 619.0
Sponsored programs	**823.7**	818.4	808.3
Patient care revenues and managed care premiums	**1,983.6**	1,990.5	1,841.2
Other	**309.4**	298.4	292.2
	3,835.4	3,783.0	3,560.7
Operating expenses	**4,433.6**	4,256.0	4,026.1
Operating loss	**(598.2)**	(473.0)	(465.4)
Nonoperating and other revenues (expenses):			
State educational appropriations	**332.4**	364.9	374.9
Private gifts	**110.7**	90.0	107.2
Net investment income	**1,572.6**	959.8	874.6
Interest expense	**(30.6)**	(27.1)	(21.7)
State capital appropriations	**6.4**	20.1	7.0
Endowment and capital gifts and grants	**159.7**	151.0	197.2
Other	**60.0**	(11.9)	6.6
Nonoperating and other revenues, net	**2,211.2**	1,546.8	1,545.8
Increase in net assets	**1,613.0**	1,073.8	1,080.4
Net assets, beginning of year	**9,884.1**	8,810.3	7,729.9
Net assets, end of year	**$ 11,497.1**	$ 9,884.1	$ 8,810.3

One of the University's greatest strengths is the diverse streams of revenue that supplement its student tuition and fees, including private support from individuals, foundations and corporations, along with government and other sponsored programs, state appropriations and investment income. The University continues to aggressively seek funding from all possible sources consistent with its mission in order to supplement student tuition and prudently manage the financial resources realized from these efforts to fund its operating activities.

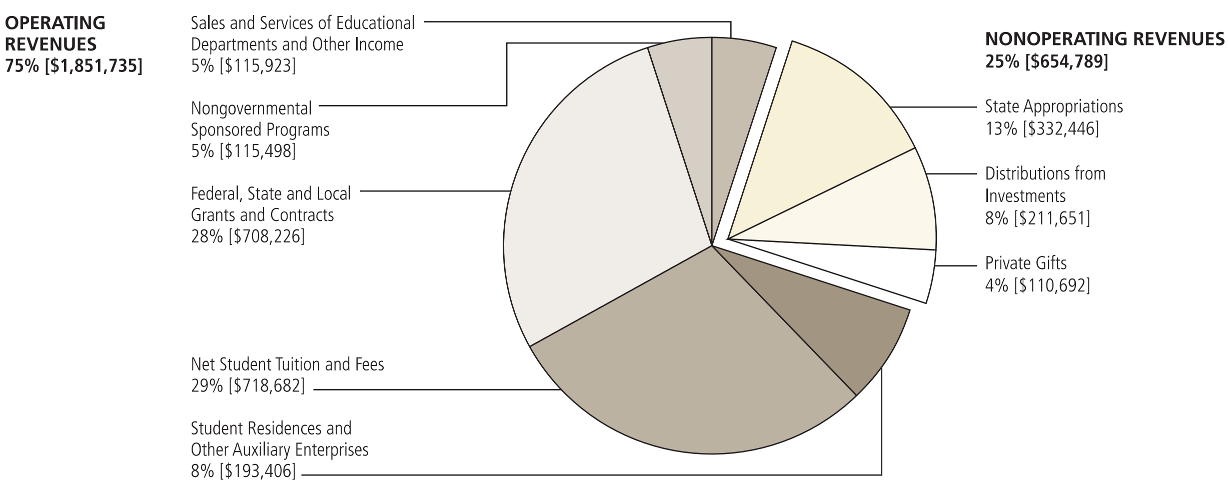
The following is a graphic illustration of revenues by source, both operating and nonoperating, which are used to fund the University's operating activities for the year ended June 30, 2007 (amounts are presented in thousands of dollars). Significant recurring sources of the University's revenues are considered nonoperating, as defined by GASB, such as state appropriations, private gifts and distributions from investments.

FISCAL YEAR 2007 REVENUES FOR OPERATING ACTIVITIES



The University measures its performance both for the University as a whole and for the University without its Health System and other similar activities. The exclusion of the Health System allows a clearer view of the operations of the schools and colleges, as well as the central administration. The following is a graphic illustration of University revenues by source, both operating and nonoperating, which are used to fund operating activities other than the Health System, for the year ended June 30, 2007 (amounts are presented in thousands of dollars).

FISCAL YEAR 2007 REVENUES FOR OPERATING ACTIVITIES EXCLUDING REVENUES FROM THE UNIVERSITY'S HEALTH SYSTEM



Tuition and state appropriations are the primary sources of funding for the University's academic programs. There is a direct relationship between the growth or reduction in state support and the University's ability to restrain tuition fee increases. Together, net student tuition and fees and state appropriations increased 1 percent, or $11 million, to $1.1 billion in 2007, as compared to a 5 percent, or $47 million, increase in 2006.

Downturns in state of Michigan tax revenues continue to put pressure on the state budget. State support has declined each year since fiscal 2002 when state educational appropriations revenue totaled $416 million. For the three years ended June 30, 2007, state educational appropriations revenue consisted of the following components:

(in millions)	**2007**	2006	2005
Base appropriations	**$ 372.8**	$ 362.0	$ 366.6
Net (rescission) restoration	**(40.4)**	2.9	8.3
	$ 332.4	$ 364.9	$ 374.9

Due to volatility in the state budget, the University's base appropriations continue to be subject to mid-year rescission and restoration. Net revenues from state educational appropriations decreased $43 million, or 11 percent, to $332 million in 2007 from 2005. The $40 million mid-year rescission in 2007 consists of a reduction in base of $6 million and a deferral of $34 million until fiscal 2008.

The net restoration in 2006 of $2.9 million represents the return of a 2005 net mid-year rescission. The net restoration in 2005 of $8.3 million primarily represents the return of a portion of the 2004 mid-year rescission of $11.2 million, which was received because the University limited its 2005 resident undergraduate tuition increases to inflation, offset by a net mid-year rescission of 2005 base appropriations of $2.9 million.

To offset the decrease in state appropriations, net student tuition and fees revenue has increased 16 percent, or $100 million, over the past two years. For the three years ended June 30, 2007, net student tuition and fees revenue consisted of the following components:

(in millions)	**2007**	2006	2005
Student tuition and fees	**$ 891.6**	$ 834.4	$ 765.2
Scholarship allowances	**(172.9)**	(158.7)	(146.2)
	$ 718.7	$ 675.7	$ 619.0

In 2007, net student tuition and fees revenue increased 6 percent, or $43 million, to $719 million, which reflects a 7 percent, or $57 million, increase in gross tuition and fee revenues offset by a 9 percent, or $14 million, increase in scholarship allowances. Tuition rate increases in 2007 averaged 5.8 percent for all undergraduate students on the Ann Arbor campus, with an 8 percent tuition rate increase for the Dearborn and Flint campuses and a 5 percent increase for most graduate tuition rates. The University also experienced a modest growth in the number of students.

In 2006, net student tuition and fees revenue increased 9 percent, or $57 million, to $676 million, which reflects a 9 percent, or $69 million, increase in gross tuition and fee revenues offset by a 9 percent, or $13 million, increase in scholarship allowances. Tuition rate increases in 2006 were 12.3 percent for resident undergraduate students on the Ann Arbor campus, with an 11.9 percent tuition rate increase for the Dearborn and Flint campuses and a 6 percent increase in most other tuition rates including those for nonresidents. The University also experienced a modest growth in the number of students.

Despite declines in state appropriations over the past five years, the University's tuition increases have been among the lowest in the state and in the Big Ten, which reflects a commitment to affordable higher education for Michigan families. At the same time, the University has also increased scholarship allowances to benefit students in financial need.

While tuition and state appropriations fund a large percentage of University costs, private support is becoming increasingly essential to the University's academic distinction. Private gifts for other than capital and endowment purposes totaled $111 million in 2007, as compared to $90 million in 2006 and $107 million in 2005.

The University receives revenues for sponsored programs from various government agencies and private sources, which normally provide for both direct and indirect costs to perform these sponsored activities. Revenues for sponsored programs increased 0.7 percent, or $6 million, to $824 million in 2007. For 2006, revenues for sponsored programs increased 1.2 percent, or $10 million, to $818 million. A significant portion of the University's sponsored programs revenues relate to federal research and its growth is consistent with the national trend of stabilized federal research activity.

Patient care revenues and managed care premiums for the three years ended June 30, 2007 is summarized as follows:

(in millions)	**2007**	2006	2005
Patient care revenues	**$ 1,786.8**	$ 1,585.4	$ 1,462.6
Managed care premiums	**196.8**	405.1	378.6
	$ 1,983.6	$ 1,990.5	$ 1,841.2

The majority of these revenues relate to patient care services, which are principally generated within the University's hospitals and ambulatory care facilities under contractual arrangements with governmental payers and private insurers. Managed care premiums represent subscription revenue recognized by M-CARE from contracts associated with employers other than the University. Patient care revenues increased 13 percent, or $201 million, to $1.8 billion in 2007, as compared to an increase of 8 percent, or $123 million, to $1.6 billion in 2006. The increased revenues for both years primarily resulted from a growth in both outpatient and inpatient volume, as well as increased reimbursement rates from third party payers. The decrease in managed care premiums in 2007 reflects the sale of M-CARE which was effective December 31, 2006.

Net investment income for the three years ended June 30, 2007 is summarized as follows:

(in millions)	**2007**	2006	2005
Interest and dividends, net	**$ 256.9**	$ 214.3	$ 195.9
Increase in fair value of investments	**1,315.7**	745.5	678.7
	$ 1,572.6	$ 959.8	$ 874.6

Net investment income totaled $1.6 billion in 2007, as compared to $960 million in 2006 and $875 million in 2005. The increase in net investment income is primarily the result of strong performance of the University's nonmarketable limited partnerships and non-US dollar equities and consistent positive returns from the University's absolute return strategies during the past three years, combined with a meaningful increase in invested balances over the same time period. The University's endowment investment policies are designed to maximize long-term total return, while its income distribution policy is designed to preserve the value of the endowment and generate a predictable stream of spendable income.

With the Michigan Difference capital campaign well underway, gifts and grants for endowment and capital purposes continue to be a significant part of sustaining the University's excellence. Private gifts for endowment purposes totaled $95 million in 2007, as compared to $86 million in 2006 and $78 million in 2005. Capital gifts and grants totaled $65 million in 2007, as compared to $65 million in 2006 and $119 million in 2005. Over the past three years, major capital gifts have been received in support of the University's wide-ranging building initiatives which include the Stephen M. Ross School of Business, Health System, Intercollegiate Athletics and College of Engineering capital projects.

Net other nonoperating revenues in 2007 include the $160 million gain on the sale of M-CARE, offset by the establishment of an $83 million liability for the University's faculty retirement furlough program. During 2007, the University recorded a liability for the program, of which $81 million is considered noncurrent. Faculty hired prior to January 1, 1984 who meet eligibility requirements are eligible for a terminal furlough year that may be taken as the last year preceding retirement or in partial installments over two or three years prior to the effective date of retirement.

In addition to revenue diversification, the University continues to make cost containment an ongoing priority. This is necessary as the University continues to face significant financial pressure, particularly in the areas of compensation and benefits, which represent 66 percent of total expenses, as well as in the areas of energy, technology and ongoing maintenance of facilities and infrastructure.

A comparative summary of the University's expenses for the three years ended June 30, 2007 is as follows:

(in millions)	2007		2006		2005	
Operating:						
Compensation and benefits	**$ 2,961.9**	**66%**	$ 2,757.9	64%	$ 2,592.1	64%
Supplies and services	**1,103.9**	**25**	1,150.2	27	1,104.9	27
Depreciation	**284.1**	**6**	264.0	6	253.7	6
Scholarships and fellowships	**83.7**	**2**	83.9	2	75.4	2
	4,433.6	**99**	4,256.0	99	4,026.1	99
Nonoperating:						
Interest	**30.6**	**1**	27.1	1	21.7	1
	$ 4,464.2	**100%**	$ 4,283.1	100%	$ 4,047.8	100%

The University is committed to recruiting and retaining outstanding faculty and staff and the compensation package is one way to successfully compete with peer institutions and nonacademic employers. The resources expended for compensation and benefits increased 7 percent, or $204 million, to $3.0 billion in 2007. Of this increase, compensation expense increased 6 percent, to $2.28 billion, and employee benefits increased 11 percent, to $685 million. For 2006, compensation increased 6 percent, to $2.14 billion, and employee benefits increased 8 percent, to $618 million.

The majority of the compensation expense increase occurred in the Health System, where nursing and other health professionals were added to support higher patient volume levels. Increases in wage rates also accounted for a significant portion of the expense growth, a reflection of the high demand for nurses and other health professionals and an industry-wide shortage of personnel in these fields. In addition, staffing levels were increased in many administrative and support areas, to further strengthen these areas and in response to the increasing regulatory burden borne by health systems.

In 2007, the Health System had a growth in compensation expense of 9 percent, which includes a growth in employees of 5 percent, while the rest of the University had a growth in compensation expense of 4 percent, with a minimal change in the number of employees. In 2006, the Health System had a growth in compensation expense of 10 percent, which includes a growth in employees of 4 percent, while the rest of the University had a growth in compensation expense of 3 percent, with a minimal change in the number of employees.

Employee benefits expense grew at a higher rate than compensation over the past two years primarily because of the rising costs of health insurance and prescription drugs. Health care benefits are one of the most significant employee benefits and over the past several years, the University has implemented several initiatives to better control its rate of increase, encourage employees to choose the lowest cost insurance plan that meets their needs and share with employees a small portion of health insurance cost increases.

The University utilizes a single pharmacy benefit administrator to manage all pharmacy benefits with University oversight. The University also actively promotes and manages generic drug utilization and has achieved a 60 percent generic dispensing rate in 2007, as compared to 57 percent in 2006 and 53 percent in 2005. In January 2006, the University unbundled pharmacy benefit claim processing and mail order services and selected separate vendors for each service to achieve better discounts for retail and mail order pricing arrangements and additional rebates.

Compared to most employers, the University is in a unique position to utilize internal experts to advise and guide its health care and drug plans. For example, the University utilizes a Pharmacy Benefits Advisory Committee, which consists of internal experts such as Health System physicians, pharmacy faculty and an on-staff pharmacist, to monitor the safety and effectiveness of covered medications as well as to optimize appropriate prescribing, dispensing and cost effective use of prescription drugs. The University also benefits from campus collaborations such as a College of Pharmacy study which was the foundation for a cost saving pill-splitting program with select cholesterol lowering drugs which began in January 2006.

Current campus collaborations include several which are part of the Michigan Healthy Community initiative, a campus-wide effort to encourage healthier living through increased activity, attention to physical safety in the workplace, and other health and wellness efforts. The health and wellness programs offered by the University through this initiative have resulted in greater integration of evidence-based wellness programming into the University's benefit programs. For example, MHealthy: Focus on Diabetes, a groundbreaking two-year pilot program, launched in July 2006, reduces or eliminates co-pays for selected medications for employees and dependents who have diabetes to encourage the proper and sustained use of specific drugs that help people manage their diabetes and to help prevent or reduce the long-term complications of the disease. The MHealthy: Focus on Medicines program, which commenced in 2007, offers employees, retirees and dependents taking nine or more prescription medications a comprehensive medication review with a university pharmacist to optimize treatment and reduce drug interaction risks.

These initiatives reflect the reality of the national landscape, while remaining true to the commitment we make to our employees for a robust benefits package.

Supplies and services expenses decreased 4 percent, or $46 million, to $1.1 billion in 2007, as compared to a 4 percent, or $45 million, increase in 2006. This reflects the impact of the sale of M-CARE effective December 31, 2006. As the majority of its expenses were non-salary, the sale of M-CARE six months into fiscal 2007 had a meaningful effect on this category of expense. Excluding the impact of M-CARE, a 7 percent increase would have been experienced in 2007.

In addition to their natural (object) classification, it is also informative to review operating expenses by function. A comparative summary of the University's expenses by functional classification for the three years ended June 30, 2007 is as follows:

(in millions)	**2007**		2006		2005	
Operating:						
Instruction	**$ 727.3**	**16%**	$ 683.0	16%	$ 669.6	17%
Research	**540.6**	**12**	519.7	12	522.8	13
Public service	**103.9**	**2**	104.9	2	102.5	2
Institutional and academic support	**378.7**	**9**	380.5	9	352.3	9
Auxiliary enterprises:						
Patient and managed care	**1,860.6**	**42**	1,843.6	43	1,719.3	42
Other	**198.5**	**4**	127.7	3	117.7	3
Operations and maintenance of plant	**256.3**	**6**	248.8	6	212.7	5
Depreciation	**284.0**	**6**	264.0	6	253.8	6
Scholarships and fellowships	**83.7**	**2**	83.8	2	75.4	2
	4,433.6	**99**	4,256.0	99	4,026.1	99
Nonoperating:						
Interest	**30.6**	**1**	27.1	1	21.7	1
	$ 4,464.2	**100%**	$ 4,283.1	100%	$ 4,047.8	100%

Instruction and public service expenses increased 5 percent, or $43 million, to $831 million in 2007, as compared to a 2 percent, or $16 million, increase in 2006. These increases are consistent with the small level of growth in the related revenue sources.

To measure its total volume of research expenditures, the University considers research expenses, included in the preceeding table, as well as research related facilities and administrative expenses, research initiative and start-up expenses, and research equipment purchases. These amounts aggregated $823 million in 2007, as compared to $797 million in 2006 and $778 million in 2005. This represents an increase of 6 percent, or $45 million, from 2005 to 2007.

Patient and managed care expenses increased 1 percent, or $17 million, to $1.9 billion in 2007, as compared to a 7 percent, or $124 million increase in 2006. This reflects the impact from the sale of M-CARE effective December 31, 2006. Excluding the impact of M-CARE, a 7 percent increase would have been experienced in 2007.

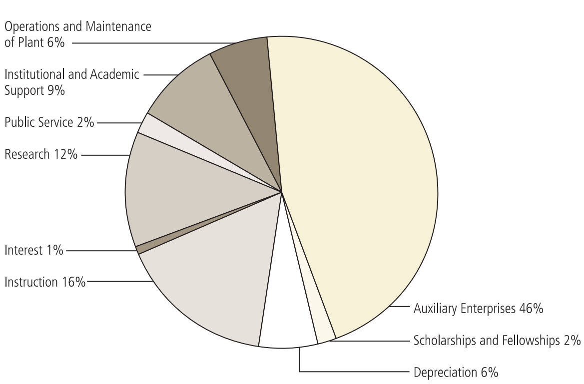
Operations and maintenance of plant expenses totaled $256 million in 2007, as compared to $249 in 2006 and $213 million in 2005. The increase from 2005 to 2007 of 20 percent, or $43 million, primarily resulted from bringing additional buildings online and rising energy prices.

Total scholarships and fellowships provided to students aggregated $272 million in 2007, as compared to $258 million in 2006 and $236 million in 2005, an increase of 15 percent over the past two years. Tuition, housing and fees revenues are reported net of aid applied to students' accounts, while amounts paid directly to students are reported as scholarship and fellowship expense. Scholarships and fellowships for the three years ended June 30, 2007 are summarized as follows:

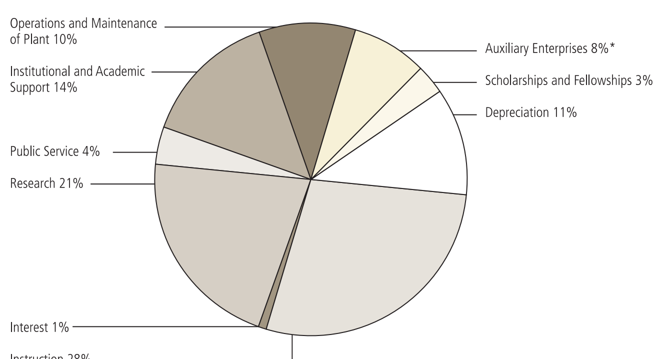
(in millions)	**2007**	2006	2005
Paid directly to students	**$ 83.7**	$ 83.8	$ 75.4
Applied to tuition and fees	**173.0**	158.7	146.2
Applied to University Housing	**15.7**	15.7	14.8
	$ 272.4	$ 258.2	$ 236.4

The following graphic illustrations present total expenses by function, with and without the University's Health System and other similar activities:

FISCAL YEAR 2007 EXPENSES BY FUNCTION



FISCAL YEAR 2007 EXPENSES BY FUNCTION EXCLUDING EXPENSES FROM THE UNIVERSITY'S HEALTH SYSTEM



* Excludes expenses from the University's Health System of $1.9 billion.

STATEMENT OF CASH FLOWS

The statement of cash flows provides additional information about the University's financial results by reporting the major sources and uses of cash. A comparative summary of the statement of cash flows for the years ended June 30, 2007 and 2006 is as follows:

(in millions)	2007	2006
Cash received from operations	$ 3,822.7	$ 3,780.7
Cash expended for operations	(4,100.9)	(4,016.9)
Net cash used in operating activities	(278.2)	(236.2)
Net cash provided by investing activities	16.9	260.4
Net cash used in capital and related financing activities	(407.6)	(514.9)
Net cash provided by noncapital financing activities	736.8	535.1
Net increase in cash and cash equivalents	67.9	44.4
Cash and cash equivalents, beginning of year	413.6	369.2
Cash and cash equivalents, end of year	$ 481.5	$ 413.6

Cash received from operations primarily consists of student tuition, sponsored program grants and contracts, and patient care revenues. Significant sources of cash provided by noncapital financing activities, as defined by GASB, include state appropriations and private gifts used to fund operating activities. In 2007, net cash from noncapital financing activities also includes proceeds from the sale of M-CARE. Cash and cash equivalents increased $68 million in 2007, as compared to an increase of $44 million in 2006.

ECONOMIC FACTORS THAT WILL AFFECT THE FUTURE

Over the last five years, the University has successfully faced significant financial challenges to its academic programs, stemming from unprecedented cuts in state appropriations. Given the continuation of this difficult state environment, it is especially impressive that the University maintains the highest credit ratings of Moody's (Aaa) and Standard & Poor's (AAA). This reflects the University's strong fiscal stewardship and its level of excellence in service to students, patients, the research community, the state and the nation. Achieving and maintaining the highest credit ratings provides the University a high degree of flexibility in securing capital funds on the most competitive terms. This flexibility, along with ongoing efforts toward revenue diversification and cost containment, will enable the University to provide the necessary resources to support this level of excellence.

A crucial element to the University's future continues to be our strong relationship with the state of Michigan. Historically, there has been a direct relationship between the growth or reduction of state support and the University's ability to control tuition increases. In adopting the budget for 2008, the University faced an unusual and highly uncertain position of finalizing the budget without fully knowing the level of appropriation from the state. To support the University's commitment to both academic excellence and access despite the state's budgetary challenges, the approved budget for 2008 includes a moderate increase in tuition rates along with an increased investment in financial aid for undergraduates.

Private gifts are an increasingly important supplement to the fundamental support provided by state appropriations and student tuition to maintain academic quality and support future initiatives. The University launched the public phase of a major fundraising campaign in May 2004, with the announcement of an ambitious goal of $2.5 billion.

The campaign, titled "The Michigan Difference", will provide support for student scholarships and fellowships, endowed professorships, facilities, academic programs, research and other projects. Since launching the quiet phase of the campaign in 2000, the University has raised $2.2 billion in cash and pledges and $390 million in bequests, a total of $2.6 billion, or 104 percent of the goal. The campaign will continue through December 2008.

The University continues to execute its long-range plan to modernize and expand its complement of older facilities while adding key new facilities for instruction, research, patient care, and residential life. This strategy addresses the University's growth and the continuing effects of technology on teaching and research methodologies. Authorized costs to complete construction and other projects totaled $756 million at June 30, 2007. Funding for these projects is anticipated to include $574 million from gifts and net assets designated for capital purposes as well as possible future borrowings, $152 million from the utilization of unexpended debt proceeds and $30 million from the State Building Authority. While the State continues to support the University's systematic renewal of core academic facilities, economic pressures may also affect the State's future support.

The University will continue to employ its long-term investment strategy to maximize total returns, at an appropriate level of risk, while utilizing a spending rate policy to preserve endowment capital and insulate the University's operations from temporary market volatility.

While the University's Hospitals and Health Centers are also well positioned to maintain a strong financial position in the near term, ongoing constraints on revenue are expected due to fiscal pressures from employers and federal and state governments. Management believes that much of the payment pressure can be offset by growth in patient volume and continued efforts to contain certain costs.

In August 2007, the University announced that a new plan will be offered for medical coverage in 2008 to replace the M-CARE HMO when the M-CARE plans are discontinued at the end of the 2007 calendar year. Called U-M Premier Care, the name of the plan reflects both the quality of coverage and the fact that it will be offered only at the University. This new plan, which will be funded by the University and administered by Blue Cross, will feature a provider network that includes all University providers and nearly the entire current M-CARE provider network.

As a labor-intensive organization, the University faces competitive pressures related to attracting and retaining faculty and staff. Moreover, consistent with the national landscape, the cost of the University's health benefits for its active employees and retirees has increased dramatically over the past several years, with the increasing cost of medical care and prescription drugs of particular concern. To address these challenges, the University has successfully taken and continues to take proactive steps to respond to the challenges of rising costs while protecting the quality of the overall benefit package.

Certain organizations are currently required to record the estimated present value of postemployment benefits as a liability in their financial statements. Although the University is not presently required to record this liability, GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* issued in June 2004, calls for the measurement and recognition of the cost of other postemployment benefits ("OPEB") during the periods when employees render their services. The University is required to implement this statement in fiscal 2008, which will result in an increase in liabilities and a decrease in net assets to reflect the actuarially determined liability for OPEB. Using current actuarial assumptions, and presuming a continuation of the current level of benefits, the value of those benefits is estimated to total $1.5 billion at June 30, 2007.

While it is not possible to predict the ultimate results, management believes that the University's financial condition will remain strong.