Notes to Consolidated Financial Statements

JUNE 30, 2007 AND 2006

NOTE 1 — ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Basis of Presentation: The University of Michigan ("the University") is a state-supported institution with an enrollment of approximately 55,000 students on its three campuses. The financial statements include the individual schools, colleges and departments, the University of Michigan Hospitals and Health Centers, Michigan Health Corporation (a wholly-owned corporation created to pursue joint venture and managed care initiatives), Veritas Insurance Corporation (a wholly-owned captive insurance company) and M-CARE (a wholly-owned health maintenance organization that was sold effective December 31, 2006). While the University is a political subdivision of the state of Michigan, it is not a component unit of the State in accordance with the provisions of Governmental Accounting Standards Board ("GASB") Statement No. 14, *The Financial Reporting Entity.* The University is classified as a state instrumentality under Internal Revenue Code Section 115, and is also classified as a charitable organization under Internal Revenue Code Section 501(c)(3), and is therefore exempt from federal income taxes. Certain activities of the University may be subject to taxation as unrelated business income under Internal Revenue Code Sections 511 to 514.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, as prescribed by the GASB, and the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Audits of State and Local Governments.* The statements of net assets, revenues, expenses and changes in net assets, and of cash flows are reported on a consolidated basis, and all intra-University transactions are eliminated as required by GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities.* The University has the option of applying pronouncements issued by the Financial Accounting Standards Board ("FASB") after November 30, 1989, provided that such pronouncements do not conflict or contradict GASB pronouncements. The University has elected not to apply any FASB pronouncements issued after the applicable date.

The financial statements of all controlled organizations are included in the University's financial statements; affiliated organizations that are not controlled by the University, such as booster and alumni organizations, are not included.

Net assets are categorized as:

- Invested in capital assets, net of related debt: Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

- Restricted:

  Nonexpendable – Net assets subject to externally imposed stipulations that they be maintained permanently. Such net assets include the corpus portion (historical value) of gifts to the University's permanent endowment funds and certain investment earnings stipulated by the donor to be reinvested permanently.

  Expendable – Net assets whose use by the University is subject to externally imposed stipulations that can be fulfilled by actions of the University pursuant to those stipulations or that expire by the passage of time. Such net assets include net appreciation of the University's permanent endowment funds that have not been stipulated by the donor to be reinvested permanently.

- Unrestricted: Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Regents or may otherwise be limited by contractual agreements with outside parties. Substantially all unrestricted net assets are designated for academic and research programs and initiatives, and capital programs.

Summary of Significant Accounting Policies: The accompanying financial statements have been prepared on the accrual basis. The University reports as a special purpose government entity engaged primarily in business type activities, as defined by GASB Statement No. 35. Business type activities are those that are financed in whole or in part by fees charged to external parties for goods or services.

For purposes of the statement of cash flows, the University considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents representing assets of the University's endowment, life income and other investments are included in noncurrent investments as these funds are not used for operating purposes.

Investments are reported in four categories in the statement of net assets. Investments reported as endowment, life income and other investments are those funds invested in portfolios that are considered by management to be of a long duration. Investments for student loan and capital activities are those funds that are intended to be used for these specific activities. All other investments are reported as operating investments.

Investment trade settlements receivable and payable relate to investment transactions occurring on or before June 30, which settle after such date.

Investments in marketable securities are carried at fair value, as established by the major securities markets. Purchases and sales of investments are accounted for on the trade date basis. Investment income is recorded on the accrual basis. Realized and unrealized gains and losses are reported in investment income.

Investments in nonmarketable limited partnerships are generally carried at fair value provided by the management of the investment partnerships as of March 31, 2007 and 2006, as adjusted by cash receipts, cash disbursements, and securities distributions through June 30, 2007 and 2006. In addition, the carrying amount of these investments is adjusted for June 30 information from management of the investment partnerships when necessary to provide a reasonable estimate of fair value as of June 30, 2007 and 2006. Because these investments are not readily marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for the investments existed and such differences could be material.

Derivative instruments, such as financial futures, forward foreign exchange contracts and interest rate swaps held in investment portfolios, are recorded on the contract date and are carried at fair value using listed price quotations or amounts that approximate fair value. To facilitate trading in financial futures, the University is required to post cash or securities to satisfy margin requirements of the exchange where such futures contracts are listed. The University monitors the required amount of cash and securities on deposit for financial futures transactions and withdraws or deposits cash or securities as necessary.

Investments denominated in foreign currencies are translated into U.S. dollar equivalents using year-end spot foreign currency exchange rates. Purchases and sales of investments denominated in foreign currencies and related income are translated at spot exchange rates on the transaction dates.

The University receives pledges and bequests of financial support from corporations, foundations and individuals. Revenue is recognized when a pledge representing an unconditional promise to pay is received and all eligibility requirements, including time requirements, have been met. In the absence of such a promise, revenue is recognized when the gift is received. Endowment pledges do not meet eligibility requirements, as defined by GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions,* and are not recorded as assets until the related gift is received.

NOTE 1 — ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — CONTINUED

Unconditional promises to give that are expected to be collected in future years are recorded at the present value of the estimated future cash flows. The discounts on these amounts are computed using risk-free interest rates applicable to the years in which the promises are made, commensurate with expected future payments. An allowance for uncollectible pledges receivable is provided based on management's judgment of potential uncollectible amounts. The determination includes such factors as prior collection history, type of gift and nature of fundraising.

Capital assets are recorded at cost or, if donated, at appraised value at the date of donation Depreciation of capital assets is provided on a straight-line basis over the estimated useful lives of the respective assets, which range from three to forty years. The University does not capitalize works of art or historical treasures that are held for exhibition, education, research or public service. These collections are neither disposed of for financial gain nor encumbered in any means. Accordingly, such collections are not recognized or capitalized for financial statement purposes.

Accrued compensation includes a liability for faculty retirement furlough. During 2007, the University recorded a liability for the program of $83,000,000, of which $81,000,000 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. The establishment of this liability is reflected as other expenses in the statement of revenues, expenses and changes in net assets.

Deferred revenue consists primarily of cash received from grant and contract sponsors which has not yet been earned under the terms of the agreement. Deferred revenue also includes amounts received in advance of an event, such as student tuition and advance ticket sales related to future fiscal years.

Deposits of affiliates and others represent cash and invested funds held by the University as a result of agency relationships with various groups. Noncurrent deposits of affiliates represent the portion of endowment and similar funds held by the University on behalf of others.

The University holds life income funds for beneficiaries of the pooled income fund, charitable remainder trusts and the gift annuity program. These funds generally pay lifetime income to beneficiaries, after which the principal is made available to the University in accordance with donor intentions. All life income fund assets, including those held in trust, are recorded at fair value, net of related liabilities for the present value of estimated future payments due to beneficiaries.

For donor restricted endowments, the Uniform Management of Institutional Funds Act, as adopted in Michigan, permits the Board of Regents to appropriate an amount of realized and unrealized endowment appreciation as determined to be prudent. The University's policy is to retain net realized and unrealized appreciation with the endowment after spending rule distributions. Net appreciation of permanent endowment funds, which totaled $1,420,000,000 and $1,022,000,000 at June 30, 2007 and 2006, respectively, is available to meet spending rate distributions and is recorded in restricted expendable net assets. The University's endowment spending rule is further discussed in Note 2.

Student tuition and residence fees are presented net of scholarships and fellowships applied to student accounts, while stipends and other payments made directly to students are presented as scholarship and fellowship expenses.

Patient care revenues are reported net of contractual allowances. Patient care services are primarily provided through the University of Michigan Health System, which includes the Hospitals and Health Centers, the Faculty Group Practice of the University of Michigan Medical School and the Michigan Health Corporation. Patient care services are also provided through University Health Services, which provides health care services to students, faculty and staff, and Dental Faculty Associates, which provides dental care services performed by faculty dentists.

Managed care premiums relate to M-CARE, a wholly-owned health maintenance organization which was sold effective December 31, 2006.

Other auxiliary enterprise revenues primarily represent revenues generated by intercollegiate athletics, parking, student unions, university press and student publications.

The University's policy for defining operating activities as reported on the statement of revenues, expenses and changes in net assets are those that generally result from exchange transactions such as payments received for providing services and payments made for services or goods received. Nearly all of the University's expenses are from exchange transactions. Certain significant revenue streams relied upon for operations are recorded as nonoperating revenues, as defined by GASB Statement No. 35, including state appropriations, gifts and investment income.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The most significant areas that require management estimates relate to self-insurance and benefits obligations.

Reclassifications: Certain prior year amounts have been reclassified to conform with current year presentations.

NOTE 2 — CASH AND INVESTMENTS

Summary: The University maintains centralized management for substantially all of its cash and investments. With the exception of certain insurance reserves, charitable remainder trusts and other funds whose terms require separate management, the University invests its cash reserves and relatively short duration assets in the University Investment Pool. The University also collectively invests substantially all of the assets of its endowment funds (University Endowment Fund) together with a portion of its insurance and benefits reserves and gift annuity program in the Long Term Portfolio.

The University Investment Pool is invested together with the University's insurance and other benefit reserves in the Daily and Monthly Portfolios, which are principally invested in investment-grade money market securities, U.S. Government and other fixed income securities and commingled funds. Balances in the University Investment Pool are primarily for operating expenses and capital projects. The funding for capital projects remains in current operating investments until amounts for specific capital projects are transferred for capital activities.

The longer investment horizon of the Long Term Portfolio allows for an equity-oriented strategy to achieve higher expected returns over time, and permits the use of less liquid alternative investments, providing for equity diversification beyond the stock markets. The Long Term Portfolio includes investments in domestic and non-U.S. stocks and bonds, commingled funds and limited partnerships consisting of venture capital, private equity, real estate, energy and absolute return strategies.

Authorizations: The University's investment policies are governed and authorized by University Bylaws and the Board of Regents. The approved asset allocation policy for the Long Term Portfolio sets a general target of 80 percent equities and 20 percent fixed income securities, within a permitted range of 65 to 90 percent for equities and 10 to 35 percent for fixed income securities. Since diversification is a fundamental risk management strategy, the Long Term Portfolio is broadly diversified within these general categories.

Distributions are made from the University Endowment Fund to the University entities that benefit from the endowment fund. The endowment spending rule provides for an annual distribution of 5 percent of the one-quarter lagged moving average fair value of fund units, limited to 5.3 percent of the current fair value to protect endowment principal in the event of a prolonged market downturn. 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. Distributions are also made from the University Investment Pool to University entities based on the 90-day U.S. Treasury Bill rate.

Cash and Cash Equivalents: Cash and cash equivalents, which totaled $481,488,000 and $413,605,000 at June 30, 2007 and 2006, respectively, represent short-term money market investments in overnight collective funds managed by the University's custodian or short-term highly liquid investments registered as securities and held by the University or its agents in the University's name. The University had actual cash balances in its bank accounts in excess of Federal Deposit Insurance Corporation limits in the amount of $8,832,000 and $16,227,000 at June 30, 2007 and 2006, respectively. The University does not require deposits to be collateralized or insured.

Investments: At June 30, 2007 and 2006, the University's investments, which are held by the University or its agents in the University's name, are summarized as follows:

(in thousands)	**2007**	2006
Cash equivalents, noncurrent	**$ 339,784**	$ 225,117
Fixed income securities	**1,753,140**	1,747,694
Commingled funds	**2,123,446**	1,885,846
Equity securities	**1,531,815**	1,440,474
Nonmarketable alternative investments	**3,067,846**	2,044,666
Other investments	**5,672**	5,988
	$ 8,821,703	$ 7,349,785

The University's investment strategy, like that of most other institutions, incorporates certain financial instruments that involve, to varying degrees, elements of market risk and credit risk in excess of amounts recorded in the financial statements. Market risk is the potential for changes in the value of financial instruments due to market changes, including interest and foreign exchange rate movements and fluctuations embodied in forwards, futures, and commodity or security prices. Market risk is directly impacted by the volatility and liquidity of the markets in which the underlying assets are traded. Credit risk is the possibility that a loss may occur due to the failure of a counterparty to perform according to the terms of the contract. The University's risk of loss in the event of a counterparty default is typically limited to the amounts recognized in the statement of net assets and is not represented by the contract or notional amounts of the instruments.

Fixed income securities have inherent financial risks, including credit risk and interest rate risk. Credit risk for fixed income securities is the risk that the issuer will not fulfill its obligations. Nationally recognized statistical rating organizations ("NSROs"), such as Moody's and Standard and Poor's, assign credit ratings to security issuers and issues that indicate a measure of potential credit risk to investors. Fixed income securities considered investment grade are those rated at least Baa by Moody's and BBB by Standard and Poor's. To manage credit risk, the University specifies minimum average and minimum absolute quality NSRO ratings for securities held pursuant to its management agreements.

The University minimizes concentration of credit risk, the risk of a large loss attributed to the magnitude of the investment in a single issuer of fixed income securities, by diversifying its fixed income issues and issuers and holding U.S. Treasury securities which are considered to have no credit risk. The University also manages this risk at the account level by limiting each fixed income manager's holding of any non-U.S. government issuer to 5 percent of the value of the investment account.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair market value of fixed income securities. Effective duration, a commonly used measure of interest rate risk, incorporates a security's yield, coupon, final maturity, call features and other imbedded options into one number expressed in years that indicates how price-sensitive a security or portfolio of securities is to changes in interest rates. The effective duration of a security or portfolio indicates the approximate percentage change in fair value expected for a one percent change in interest rates. The longer the duration, the more sensitive the security or portfolio is to changes in interest rates. The weighted average effective duration of the University's fixed income securities was 4.1 years at June 30, 2007, compared to 4.0 years at June 30, 2006. The University manages the effective duration of its fixed income securities at the account level; fixed income managers generally may not deviate from the duration of their respective benchmarks by more than 25 percent.

NOTE 2 — CASH AND INVESTMENTS — CONTINUED

The composition of fixed income securities at June 30, 2007 and 2006, along with credit quality and effective duration measures, is summarized as follows:

2007

(in thousands)	U.S. Government	Investment Grade	Non-Investment Grade	Not Rated	Total	Duration (in years)
U.S. Treasury	$ 391,214				$ 391,214	9.7
U.S. Treasury Inflation Protected	370,881				370,881	4.1
U.S. Government agency	110,851				110,851	1.9
Mortgage backed		$ 211,656		$ 4,187	215,843	1.7
Asset backed		70,290		2,503	72,793	0.7
Corporate and other		449,099	$ 25,631	116,828	591,558	2.3
	$ 872,946	$ 731,045	$ 25,631	$ 123,518	$ 1,753,140	4.1

2006

(in thousands)	U.S. Government	Investment Grade	Non-Investment Grade	Not Rated	Total	Duration (in years)
U.S. Treasury	$ 388,425				$ 388,425	8.2
U.S. Treasury Inflation Protected	369,041				369,041	3.8
U.S. Government agency	215,074				215,074	1.9
Mortgage backed		$ 165,565		$ 1,239	166,804	1.7
Asset backed		82,034		2	82,036	0.8
Corporate and other		382,114	$ 26,428	90,115	498,657	2.3
Municipal		24,927		2,730	27,657	15.7
	$ 972,540	$ 654,640	$ 26,428	$ 94,086	$ 1,747,694	4.0

Of the University's fixed income securities, 91 percent and 93 percent were rated investment grade or better at June 30, 2007 and 2006, with 70 percent and 74 percent of these securities rated AAA/Aaa or better at June 30, 2007 and 2006, respectively.

Commingled (pooled) funds include Securities and Exchange Commission regulated mutual funds and externally managed funds, limited partnerships, and corporate structures which are generally unrated and unregulated. The composition of commingled funds at June 30, 2007 and 2006 is summarized as follows:

(in thousands)	**2007**	2006
Absolute return	**$ 1,178,374**	$ 1,069,519
U.S. equities	**115,207**	104,562
Non-U.S./global equities	**736,080**	563,862
U.S. fixed income	**81,542**	88,395
Other	**12,243**	59,508
	$ 2,123,446	$ 1,885,846

Commingled funds have liquidity (redemption) provisions, which enable annual or more frequent withdrawals subject to notice requirements of up to 90 days. Certain commingled funds held in the Long Term Portfolio and the Daily and Monthly Portfolios may use derivatives, short positions and leverage as part of their investment strategy. These investments are structured to limit the University's risk exposure to the amount of invested capital.

Nonmarketable alternative investments consist of limited partnerships involving an advance commitment of capital called by the general partner as needed and distributions of capital and return on invested capital as underlying strategies are concluded during the life of the partnership. The composition of these partnerships at June 30, 2007 and 2006 is summarized as follows:

(in thousands)	**2007**	2006
Private equity	**$ 836,956**	$ 528,695
Real estate	**749,763**	538,859
Absolute return	**527,368**	279,396
Energy	**535,707**	434,942
Venture capital	**418,052**	262,774
	$ 3,067,846	$ 2,044,666

The University's committed but unpaid obligation to these limited partnerships is further discussed in Note 12.

Absolute return strategies in the commingled funds and nonmarketable alternative investments classifications include long/short stock programs, merger arbitrage, intra-capital structure arbitrage and distressed debt investments. The goal of absolute return strategies is to provide, in aggregate, a return that is consistently positive and uncorrelated with the overall market.

The University participates in non-U.S. developed and emerging markets through commingled funds invested in non-U.S./global equities and absolute return strategies. The University's investments also include securities denominated in foreign currencies, which must be settled in local (non-U.S.) currencies. Forward foreign currency contracts are typically used to manage the risk related to fluctuations in currency exchange rates between the time of purchase or sale and the actual settlement of foreign securities. Various investment managers acting for the University also use forward foreign exchange contracts in risk-based transactions to carry out their portfolio strategies.

NOTE 2 — CASH AND INVESTMENTS — CONTINUED

Foreign exchange risk is the risk that investments denominated in foreign currencies may lose value due to adverse fluctuations in the value of the U.S. dollar relative to foreign currencies. The University's non-U.S. dollar holdings amounted to $1,117,741,000, or 13 percent of total investments, at June 30, 2007, as compared to $864,361,000, or 12 percent of total investments, at June 30, 2006. The University's total net exposure to foreign currencies including forward foreign exchange contracts and other derivatives amounted to $507,796,000 and $1,320,901,000 at June 30, 2007 and 2006, respectively. The University manages foreign exchange risk through manager agreements that provide minimum diversification and maximum exposure limits by country and currency.

The Long Term Portfolio and the Daily and Monthly Portfolios hold positions in bond and stock index futures contracts. Bond futures are used to adjust the duration of cash equivalents and the fixed-income portion of the portfolios. Stock index futures are used to overlay cash equivalents and more closely align the portfolios' asset class exposures with asset allocation targets. To meet trading margin requirements, the University has deposited U.S. Government securities and cash with a fair value of $20,575,000 and $21,338,000 at June 30, 2007 and 2006, respectively, with its futures contract broker as collateral.

The Long Term Portfolio and the Daily and Monthly Portfolios, together, had fully collateralized short-term securities loans of $864,179,000 and $743,484,000 at June 30, 2007 and 2006, respectively, through a securities lending program administered by the University's master custodian. At loan inception, an approved borrower must deliver collateral of cash, securities or letters of credit to the University's lending agent equal to 102 percent for domestic securities and 105 percent for foreign securities. Collateral positions are monitored daily to insure that borrowed securities are never less than 100 percent collateralized. The fair value of the collateral totaled $890,544,000, or 103 percent of the fair value of the securities on loan, at June 30, 2007, as compared to $766,131,000, or 103 percent of the fair value of securities on loan, at June 30, 2006. Neither the University nor its securities lending agent has the ability to pledge or sell collateral securities unless a borrower defaults. Securities loans may be terminated upon notice by either the University or the borrower.

NOTE 3 — ACCOUNTS RECEIVABLE

The composition of accounts receivable at June 30, 2007 and 2006 is summarized as follows:

(in thousands)	**2007**	2006
Patient care	**$ 303,960**	$ 252,417
Sponsored programs	**75,959**	70,647
State appropriations, educational and capital	**28,460**	69,642
Student accounts	**20,145**	22,287
Other	**26,886**	30,115
	455,410	445,108
Less provision for uncollectible accounts receivable	**74,563**	56,879
	$ 380,847	$ 388,229

NOTE 4 — NOTES AND PLEDGES RECEIVABLE

The composition of notes and pledges receivable at June 30, 2007 and 2006 is summarized as follows:

(in thousands)	2007	2006
Notes:		
Federal student loan programs	$ 99,601	$ 95,482
University student loan funds	17,041	15,706
Other	726	882
	117,368	112,070
Less allowance for doubtfully collectible notes	2,300	2,300
Total notes receivable, net	115,068	109,770
Gift pledges outstanding:		
Capital	148,910	157,384
Operations	72,561	60,260
	221,471	217,644
Less:		
Allowance for doubtfully collectible pledges	6,961	15,905
Unamortized discount to present value	20,045	20,114
Total pledges receivable, net	194,465	181,625
Total notes and pledges receivable, net	309,533	291,395
Less current portion	62,385	64,516
	$ 247,148	$ 226,879

The principal repayment and interest rate terms of federal and university loans vary considerably. The allowance for doubtfully collectible notes only applies to University funded notes and the University portion of federal student loans, as the University is not obligated to fund the federal portion of uncollected student loans. Federal loan programs are funded principally with federal advances to the University under the Perkins and various health professions loan programs.

Payments on pledges receivable at June 30, 2007 are expected to be received in the following years ended June 30 (in thousands):

2008	$ 47,010
2009-2012	141,291
2013 and after	33,170
	$ 221,471

As discussed in Note 1, pledges for permanent endowment do not meet eligibility requirements, as defined by GASB Statement No. 33, until the related gift is received. Accordingly, permanent endowment pledges totaling approximately $96,360,000 and $67,606,000 at June 30, 2007 and 2006, respectively, are not recognized as assets in the accompanying financial statements. In addition, bequest intentions and other conditional promises are not recognized as assets until the specified conditions are met because of uncertainties with regard to their realizability and valuation.

NOTE 5 — CAPITAL ASSETS

Capital assets activity for the years ended June 30, 2007 and 2006 is summarized as follows:

2007

(in thousands)	Beginning Balance	Additions	Retirements	Ending Balance
Land	$ 81,278	$ 530		$ 81,808
Land improvements	91,452	2,435		93,887
Infrastructure	146,809	17,282		164,091
Buildings	3,957,478	547,580	$ 23,966	4,481,092
Construction in progress	557,036	(208,145)		348,891
Equipment	1,178,658	230,900	64,014	1,345,544
Library materials	365,894	20,126		386,020
	6,378,605	610,708	87,980	6,901,333
Less accumulated depreciation	2,925,164	284,048	63,277	3,145,935
	$ 3,453,441	$ 326,660	$ 24,703	$ 3,755,398

2006

(in thousands)	Beginning Balance	Additions	Retirements	Ending Balance
Land	$ 80,795	$ 493	$ 10	$ 81,278
Land improvements	89,596	1,856		91,452
Infrastructure	132,028	14,781		146,809
Buildings	3,424,929	543,457	10,908	3,957,478
Construction in progress	647,538	(90,502)		557,036
Equipment	1,087,249	127,354	35,945	1,178,658
Library materials	346,857	19,037		365,894
	5,808,992	616,476	46,863	6,378,605
Less accumulated depreciation	2,703,524	264,028	42,388	2,925,164
	$ 3,105,468	$ 352,448	$ 4,475	$ 3,453,441

The decrease in construction in progress of $208,145,000 in 2007 represents the amount of capital assets placed in service of $560,193,000 net of capital expenditures for new projects of $352,048,000.The decrease in construction in progress of $90,502,000 in 2006 represents the amount of capital assets placed in service of $642,445,000 net of capital expenditures for new projects of $551,943,000.

NOTE 6 — LONG-TERM DEBT

Long-term debt at June 30, 2007 and 2006 is summarized as follows:

(in thousands)	**2007**	2006
Commercial Paper:		
Tax-exempt, variable rate (3.67%)*	**$ 103,125**	$ 89,665
Taxable, variable rate (5.28%)*	**7,075**	7,375
General Revenue Bonds:		
Series 2005A, 5.00% through 2018	**37,745**	37,745
unamortized premium	**3,097**	3,695
unamortized loss on extinguishment	**(400)**	(484)
Series 2005B, variable rate (3.70%)* through 2035	**48,020**	48,020
Series 2002, variable rate (3.73%)* to fixed via swap through 2018 and variable rate 2019 through 2032	**130,090**	133,605
General Revenue Refunding Bonds:		
Series 2003, 3.50% to 5.00% through 2015	**34,660**	40,855
unamortized premium	**2,175**	2,910
unamortized loss on extinguishment	**(399)**	(541)
Hospital Revenue Bonds:		
Series 2007A, variable rate (3.90%)* through 2038	**50,120**	
Series 2007B, variable rate (3.73%)* through 2038	**100,235**	
Series 2005A, variable rate (3.90%)* through 2036	**69,315**	69,315
Series 2005B, variable rate (3.73%)* to fixed via swap through 2026	**78,085**	81,000
Series 1995A, variable rate (3.75%)* through 2028	**100,000**	100,000
Hospital Revenue Refunding Bonds:		
Series 2002A, 5.00% to 5.25% through 2022	**67,125**	75,500
unamortized premium	**1,747**	2,368
unamortized loss on extinguishment	**(2,700)**	(3,105)
Series 1998A-1, 5.25% through 2011	**16,540**	16,540
unamortized premium	**129**	167
Series 1998A-2, variable rate (3.90%)* to fixed via swap through 2025	**44,670**	44,670
Series 1992A, variable rate (3.90%)* through 2020	**56,000**	56,000
Medical Service Plan Revenue Bonds:		
Series 1998A-1, variable rate (3.90%)* to fixed via swap through 2022	**35,350**	35,655
Series 1995A, variable rate (3.75%)* through 2028	**49,300**	49,800
Series 1991, 6.85% to 7.05% capital appreciation through 2012	**9,290**	10,801
Housing Revenue Bonds, Series 1996A, 5.13% to 5.60%		11,480
Housing Energy Conservation HUD Loan, 3.00% through 2021	**2,372**	2,506
Student Fee Bonds, Series 1995A-B, 6.00%		2,830
Total long-term debt	**1,042,766**	918,372
Less current portion of long-term debt	**145,148**	136,851
	$ 897,618	$ 781,521

* Denotes rate at June 30, 2007

NOTE 6 — LONG-TERM DEBT — CONTINUED

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

(in thousands)	Beginning Balance	Additions	Reductions	Ending Balance
Commercial Paper:				
General revenues	$ 97,040	$ 52,015	$ 38,855	$ 110,200
Bonds and Notes:				
General revenues	265,805		10,817	254,988
Hospital revenues	442,455	150,355	11,544	581,266
Faculty Group Practice revenues	96,256	689	3,005	93,940
Student residences revenues	13,986		11,614	2,372
Student fee revenues	2,830		2,830	-
	$ 918,372	$ 203,059	$ 78,665	$ 1,042,766

The University maintains a combination of variable and fixed rate debt, with effective interest rates that averaged 4.04 percent in fiscal 2007 and 3.75 percent in fiscal 2006. The University utilizes commercial paper to provide interim financing for its capital improvement program. The Board of Regents has authorized the issuance of up to $150,000,000 in commercial paper backed by a general revenue pledge. Outstanding commercial paper debt is converted to long-term debt financing, as appropriate, within the normal course of business.

During fiscal 2007, the University issued $52,015,000 of commercial paper to fund new construction projects. During fiscal 2006, the University issued $98,835,000 of commercial paper to fund $81,525,000 of new construction projects and rollover $17,310,000 of outstanding commercial paper into a new series.

In April 2007, the University issued $150,355,000 of variable rate Hospital Revenue Bonds. Bond proceeds were used to convert $24,395,000 of commercial paper and provide $125,605,000 for capital projects and $355,000 for debt issuance fees. Of the total bond issue, $50,120,000 (Series 2007A) is variable based on a daily rate mode and $100,235,000 (Series 2007B) is variable based on a weekly rate mode.

In November 2006, a portion of the proceeds from the Series 2005 General Revenue Bonds was used to redeem $10,800,000 of Series 1996 Housing Revenue Bonds previously called for redemption.

Debt obligations are generally callable by the University and mature at various dates through fiscal year 2038. Principal maturities and interest on debt obligations for the next five years and in subsequent five-year periods are as follows:

(in thousands)	Principal	Interest*	Total
2008	$ 143,990	$ 36,785	$ 180,775
2009	33,853	35,010	68,863
2010	33,780	33,733	67,513
2011	34,884	32,373	67,257
2012	38,123	30,910	69,033
2013-2017	181,099	127,678	308,777
2018-2022	183,491	92,907	276,398
2023-2027	198,930	55,138	254,068
2028-2032	112,830	23,761	136,591
2033-2037	69,675	7,590	77,265
2038	8,462	135	8,597
	1,039,117	$ 476,020	$ 1,515,137
Plus unamortized premiums, net	3,649		
	$ 1,042,766		

* Interest on variable rate debt is estimated based on rates in effect at June 30, 2007

During fiscal 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 $58,000,000 at June 30, 2007. The swap agreement converts the floating variable rate on these bonds to a fixed rate of 3.54 percent commencing June 2007 through April 2018. The University makes fixed rate interest payments to the counterparty and receives a variable rate payment based on 68 percent of the One-Month USD LIBOR through April 2009 and 63 percent of the Five-Year USD LIBOR Swap Rate for the balance of the term. The University has the option to terminate the swap upon five business days written notice and payment of the fair market compensation for the value of the swap.

In connection with the issuance of the Series 2005B Hospital Revenue Bonds, the University entered into a floating-to-fixed interest rate swap agreement for a notional amount tied to the outstanding balance of the bonds. The swap agreement converts the floating variable rate on these bonds to a fixed rate of 3.23 percent commencing December 2005 through December 2025, the final maturity of the underlying bonds. The University makes fixed rate interest payments to the counterparty and receives a variable rate payment based on 68 percent of the One-Month USD LIBOR. The University has the option to terminate the swap upon five business days written notice and payment of the fair market compensation for the value of the swap.

In connection with the issuance of the Series 1998A-2 Hospital Revenue Refunding Bonds and the Series 1998A-1 Medical Service Plan Revenue Bonds, the University entered into floating-to-fixed interest rate swap agreements for notional amounts tied to the outstanding balance of the bonds. The swap agreements convert the floating variable rates on these Hospital and Medical Service Plan bonds to fixed rates of 4.71 percent and 4.69 percent, respectively, through December 2024 and December 2021, the final maturity dates of the underlying bonds.The University makes fixed rate interest payments to the counterparty and receives a variable rate payment based on the floating Bond

NOTE 6 — LONG-TERM DEBT — CONTINUED

Market Association Municipal Swap Index. The counterparty has the option of terminating the swaps if for any 180-day period the average variable rate is more than 7.0 percent.

The estimated fair value of the interest rate swaps was a liability of $871,000 at June 30, 2007 and a liability of $785,000 at June 30, 2006. The fair value represents the estimated amount that the University would pay to terminate the swap agreements at the statement of net assets date, taking into account current interest rates and creditworthiness of the underlying counterparty. In accordance with governmental accounting standards, these amounts are not required to be included in the accompanying financial statements.

The University maintains unsecured lines of credit with three major commercial banks to support the liquidity requirements of variable rate debt. Available lines of credit, which totaled $450,000,000 at June 30, 2007 and $400,000,000 at June 30, 2006, were entirely unused during fiscal 2007 and 2006.

NOTE 7 — SELF-INSURANCE

The University is self-insured for medical malpractice, workers' compensation, directors and officers' liability, property damage, auto liability and general liability through Veritas Insurance Corporation, a wholly-owned captive insurance company. The University is also self-insured for various employee benefits through internally maintained funds.

Claims and expenses are reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. Those losses include an estimate of claims that have been incurred but not reported and the future costs of handling claims. These liabilities are generally based on actuarial valuations and are reported at present value, discounted at rates which range from 5 to 6 percent.

Changes in the total reported liabilities for insurance and benefits obligations for the years ended June 30, 2007 and 2006 are summarized as follows:

(in thousands)	**2007**	2006
Balance, beginning of year	**$ 212,099**	$ 223,010
Claims incurred and changes in estimates	**181,837**	141,879
Claim payments	**(165,047)**	(152,790)
Balance, end of year	**228,889**	212,099
Less current portion	**62,042**	55,986
	$ 166,847	$ 156,113

NOTE 8 — UNRESTRICTED NET ASSETS

Unrestricted net assets, as defined by GASB Statement No. 35, are not subject to externally imposed stipulations; however, they are subject to internal restrictions. For example, unrestricted net assets may be designated for specific purposes by action of management or the Board of Regents or may otherwise be limited by contractual agreements with outside parties. All of the unrestricted net assets, which totaled $4,067,974,000 at June 30, 2007, have been designated for academic and research programs and initiatives, and capital programs.

NOTE 9 — RETIREMENT PLAN

The University has a defined contribution retirement plan for all qualified employees through the Teachers Insurance and Annuity Association – College Retirement Equities Fund (“TIAA-CREF”) and Fidelity Management Trust Company (“FMTC”) mutual funds. All regular and supplemental instructional and primary staff are eligible to participate in the plan based upon age and service requirements. Participants maintain individual contracts with TIAA-CREF, or accounts with FMTC, and are fully vested.

Eligible employees generally contribute 5 percent of their pay and the University generally contributes an amount equal to 10 percent of employees’ pay to the plan. Participants may elect to contribute additional amounts to the plan within specified limits that are not matched by University contributions. Contributions and covered payroll under the plan (excluding participants’ additional contributions) for the three years ended June 30, 2007 are summarized as follows:

(in thousands)	**2007**	2006	2005
University contributions	**$ 183,145**	$ 171,868	$ 160,455
Employee contributions	**$ 90,252**	$ 84,706	$ 79,005
Payroll covered under plan	**$ 2,172,592**	$ 2,001,670	$ 1,913,449
Total payroll	**$ 2,292,929**	$ 2,155,752	$ 2,039,130

NOTE 10 — POSTEMPLOYMENT BENEFITS

In addition to the retirement benefits discussed in Note 9, the University provides certain health care and other postemployment benefits for retired employees. Substantially all of the approximately 32,000 permanent University employees may become eligible for these benefits if they reach retirement age while working for the University.

Health care benefits for the approximately 9,100 retirees and survivors, including dependents, at June 30, 2007 are provided through insurance companies and health maintenance organizations, whose premiums are based in part on the benefits paid. The University recognizes the cost of providing these benefits on a pay-as-you-go basis, which is included in operating expenses and amounted to approximately $32,600,000 and $32,055,000 for the years ended June 30, 2007 and 2006, respectively. Other postemployment benefits, principally life insurance and dental, are also included in operating expenses, and amounted to approximately $2,489,000 and $2,405,000 for the years ended June 30, 2007 and 2006, respectively.

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 statement also establishes more comprehensive disclosure for OPEB obligations. OPEB refers to postemployment benefits other than pension benefits and includes postemployment health care benefits and other types of postemployment benefits if provided separately from a pension plan. 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. Based on current actuarial assumptions and presuming a continuation of the current level of benefits, the value of those benefits is estimated at $1,470,000,000 at June 30, 2007. Statement No. 45 provides for various methods of calculating and recording the OPEB liability; accordingly, the liability recorded by the University upon implementation may differ from current estimates.

NOTE 11 — FEDERAL DIRECT LENDING PROGRAM

The University distributed $220,480,000 and $202,117,000 for the years ended June 30, 2007 and 2006, respectively, for student loans through the U.S. Department of Education ("DoED") federal direct lending program. These distributions and related funding sources are not included as expenses and revenues in the accompanying financial statements. The statement of net assets includes a payable of $4,329,000 and $5,022,000 at June 30, 2007 and 2006, respectively, for DoED funding received in advance of distribution.

NOTE 12 — COMMITMENTS AND CONTINGENCIES

Authorized expenditures for construction and other projects unexpended as of June 30, 2007 were $756,373,000. Of these expenditures, approximately $29,717,000 will be funded by the State Building Authority, $152,446,000 will be funded using unexpended debt proceeds, and the remaining $574,210,000 will be funded by internal sources, gifts and possible future borrowings.

Under the terms of various limited partnership agreements approved by the Board of Regents or by University officers, the University is obligated to make periodic payments for advance commitments to venture capital, private equity, real estate, energy and absolute return strategies. As of June 30, 2007, the University had committed, but not paid, a total of $2,675,310,000 in funding for these alternative investments. Outstanding commitments for such investments are anticipated to be paid in the following years ended June 30 (in thousands):

2008	$ 951,504
2009	651,321
2010	454,702
2011	216,662
2012 and beyond	401,121
	$ 2,675,310

The University is a party to various pending legal actions and other claims in the normal course of business, and is of the opinion that the outcome thereof will not have a material adverse effect on its financial position.

NOTE 13 — SEGMENT INFORMATION

A segment is an identifiable activity reported as a stand-alone entity for which one or more revenue bonds are outstanding. A segment has a specific identifiable revenue stream pledged in support of revenue bonds and has related expenses, gains and losses, assets and liabilities that are required by an external party to be accounted for separately. The University has one segment that meets the reporting requirements of GASB Statement No. 35.

The University of Michigan Hospitals and Health Centers ("HHC") operates several health care facilities and programs in southeastern Michigan, providing hospital care, ambulatory care, and other health services. HHC serves as the principal teaching facility for the University of Michigan Medical School. The faculty of the Medical School provides substantially all physician services to HHC through its Faculty Group Practice.

HHC outstanding debt, referred to as Hospital Revenue Bonds and Hospital Revenue Refunding Bonds, was issued pursuant to a Master Indenture Agreement, dated May 1, 1986. These bonds are solely payable from, and secured by, a pledge of hospital gross revenues, as defined in the Master Indenture. The University, as permitted by the Master Indenture, has further defined hospital gross revenues pledged to exclude revenues deemed to be associated with the Faculty Group Practice.

Condensed financial information for HHC, before the elimination of certain intra-University transactions, as of and for the years ended June 30, 2007 and 2006 is as follows:

(in thousands)	2007	2006
Condensed Statement of Net Assets		
Assets:		
Current assets	**$ 356,547**	$ 350,172
Noncurrent assets	**2,379,252**	1,991,909
Total assets	**$ 2,735,799**	$ 2,342,081
Liabilities:		
Current liabilities	**$ 163,633**	$ 142,256
Noncurrent liabilities	**576,017**	435,686
Total liabilities	**739,650**	577,942
Net assets:		
Invested in capital assets, net of related debt	**533,475**	425,529
Restricted	**52,634**	51,727
Unrestricted	**1,410,040**	1,286,883
Total net assets	**1,996,149**	1,764,139
Total liabilities and net assets	**$ 2,735,799**	$ 2,342,081
Condensed Statement of Revenues, Expenses and Changes in Net Assets		
Operating revenues	**$ 1,561,198**	$ 1,435,330
Operating expenses other than depreciation expense	**(1,400,029)**	(1,255,812)
Depreciation expense	**(99,476)**	(92,510)
Operating income	**61,693**	87,008
Nonoperating revenues, net	**244,925**	196,131
Excess of revenues over expenses	**306,618**	283,139
Transfers to other University units, net	**(74,608)**	(70,578)
Increase in net assets	**232,010**	212,561
Net assets, beginning of year	**1,764,139**	1,551,578
Net assets, end of year	**$ 1,996,149**	$ 1,764,139
Condensed Statement of Cash Flows		
Net cash flows provided by operating activities	**$ 149,799**	$ 191,386
Net cash flows (used in) provided by investing activities	**(328)**	162,755
Net cash flows used in capital and related financing activities	**(104,588)**	(244,210)
Net cash flows used in noncapital financing activities	**(70,205)**	(77,790)
Net (decrease) increase in cash and cash equivalents	**(25,322)**	32,141
Cash and cash equivalents, beginning of year	**107,703**	75,562
Cash and cash equivalents, end of year	**$ 82,381**	$ 107,703

NOTE 14 — OPERATING EXPENSES BY FUNCTION

Operating expenses by functional classification for the years ended June 30, 2007 and 2006 are summarized as follows:

2007

(in thousands)	Compensation and Benefits	Supplies and Services	Depreciation	Scholarships and Fellowships	Total
Instruction	$ 631,262	$ 96,082			$ 727,344
Research	376,184	164,421			540,605
Public service	73,985	29,934			103,919
Academic support	146,090	28,438			174,528
Student services	56,114	14,865			70,979
Institutional support	111,011	22,218			133,229
Operations and maintenance of plant	37,231	219,020			256,251
Auxiliary enterprises	1,530,037	528,950			2,058,987
Depreciation			$ 284,048		284,048
Scholarships and fellowships				$ 83,712	83,712
	$ 2,961,914	$ 1,103,928	$ 284,048	$ 83,712	$ 4,433,602

2006

(in thousands)	Compensation and Benefits	Supplies and Services	Depreciation	Scholarships and Fellowships	Total
Instruction	$ 591,160	$ 91,854			$ 683,014
Research	364,727	154,991			519,718
Public service	73,808	31,056			104,864
Academic support	137,913	37,948			175,861
Student services	53,764	13,205			66,969
Institutional support	106,831	30,787			137,618
Operations and maintenance of plant	35,402	213,436			248,838
Auxiliary enterprises	1,394,315	576,937			1,971,252
Depreciation			$ 264,028		264,028
Scholarships and fellowships				$ 83,839	83,839
	$ 2,757,920	$ 1,150,214	$ 264,028	$ 83,839	$ 4,256,001

NOTE 15 — SALE OF M-CARE

The University sold M-CARE, its wholly-owned health maintenance organization, to Blue Cross Blue Shield of Michigan effective December 31, 2006. Proceeds from the sale, net of expenses, totaled $257,523,000 and the University recognized a gain on the sale of $159,743,000 in fiscal 2007, which is included in other revenues in the statement of revenues, expenses and changes in net assets. 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. Subscription premiums revenue recognized by M-CARE from employers other than the University totaled approximately $196,800,000 and $405,100,000 for the six months ended December 31, 2006 and the year ended June 30, 2006, respectively.