Notes to Consolidated Financial Statements

JUNE 30, 2008 AND 2007

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 57,000 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.

During fiscal 2008, the University implemented GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* This statement requires accrual-based measurement and recognition of the cost of postemployment benefits during the periods when employees render their services. Previously, the University recorded obligations for most postemployment benefits as they were paid. Implementation of this Statement resulted in an increase in liabilities and a decrease in net assets of $1,491,813,000 in fiscal 2008. Of this increase, $1,306,859,000 represents a one-time nonoperating expense to reflect the present value of the University's obligations for postemployment benefits as of July 1, 2007 and $97,267,000 represents the additional fiscal 2008 operating expense for postemployment benefit obligations. In addition, insurance and benefit reserves for life insurance and open long-term disability claims, which totaled $87,687,000 at June 30, 2007, are considered postemployment benefits as defined by GASB Statement No. 45 and have been reclassified to the liability for postemployment benefit obligations as part of the implementation of this Statement.

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, 2008 and 2007, as adjusted by cash receipts, cash disbursements, and securities distributions through June 30, 2008 and 2007. 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, 2008 and 2007. 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.

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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.

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.

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 $1,492,000,000 and $1,420,000,000 at June 30, 2008 and 2007, 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.

New Accounting Pronouncements: In November 2006, the GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations,* effective for the University's fiscal year beginning July 1, 2008. This Statement establishes criteria to ascertain whether certain events result in a requirement for the University to estimate the components of any expected pollution remediation costs and determine whether these costs should be accrued as a liability or, if appropriate, capitalized.

In June 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets,* effective for the University's fiscal year beginning July 1, 2009. This Statement requires capitalization of identifiable intangible assets in the statement of net assets and provides guidance for amortization of intangible assets unless they are considered to have an indefinite useful life.

In June 2008, the GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments,* effective for the University's fiscal year beginning July 1, 2009. This Statement requires derivative instruments to be reported at fair value. In addition, for derivative instruments that qualify as effective hedges, changes in fair value will be reported as deferrals in the statement of net assets, while changes in the fair value of derivative instruments that do not qualify as an effective hedge, including investment derivative instruments, will be reported as investment income. This Statement also requires additional disclosures about the University's derivative instruments.

The University is evaluating the effect that these Statements will have on its financial statements.

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, charitable remainder trusts 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 absolute return strategies. 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. The University's costs to administer and grow the University Endowment Fund and University Investment Pool are funded by investment income.

Cash and Cash Equivalents: Cash and cash equivalents, which totaled $495,137,000 and $481,488,000 at June 30, 2008 and 2007, 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 $17,667,000 and $8,832,000 at June 30, 2008 and 2007, respectively. The University does not require deposits to be collateralized or insured.

Investments: At June 30, 2008 and 2007, the University's investments, which are held by the University or its agents in the University's name, are summarized as follows:

(in thousands)	2008	2007
Cash equivalents, noncurrent	$ 239,043	$ 339,784
Fixed income securities	1,663,408	1,753,140
Commingled funds	2,075,546	2,123,446
Equity securities	1,171,267	1,531,815
Nonmarketable alternative investments	4,111,493	3,067,846
Other investments	7,161	5,672
	$ 9,267,918	$ 8,821,703

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 4.7 years at June 30, 2008, compared to 4.1 years at June 30, 2007. 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, 2008 and 2007, along with credit quality and effective duration measures, is summarized as follows:

2008

(in thousands)	U.S. Government	Investment Grade	Non-Investment Grade	Not Rated	Total	Duration (in years)
U.S. Treasury	$ 70,900				$ 70,900	3.6
U.S. Treasury Inflation Protected	489,523				489,523	4.4
U.S. Government agency	126,522				126,522	1.6
Mortgage backed		$ 123,464			123,464	2.7
Asset backed		56,035		$ 3	56,038	5.7
Corporate and other		773,542	$ 22,960	459	796,961	5.8
	$ 686,945	$ 953,041	$ 22,960	$ 462	$ 1,663,408	4.7

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

Of the University's fixed income securities, 99 percent and 91 percent were rated investment grade or better at June 30, 2008 and 2007, with 57 percent and 70 percent of these securities rated AAA/Aaa or better at June 30, 2008 and 2007, 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, 2008 and 2007 is summarized as follows:

(in thousands)	2008	2007
Absolute return	$ 1,177,265	$ 1,178,374
U.S. equities	152,614	115,207
Non-U.S./global equities	644,542	736,080
U.S. fixed income	79,782	81,542
Other	21,343	12,243
	$ 2,075,546	$ 2,123,446

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, 2008 and 2007 is summarized as follows:

(in thousands)	2008	2007
Private equity	$ 1,074,706	$ 836,956
Real estate	969,778	749,763
Absolute return	715,916	527,368
Energy	849,458	535,707
Venture capital	501,635	418,052
	$ 4,111,493	$ 3,067,846

While the University's limited partnership investments are diversified in terms of manager selection and industry and geographic focus, one energy partnership represented 6 percent, or $540,000,000, of total investments at June 30, 2008. 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. Although substantially all of these funds are reported in U.S. dollars, both price changes of the underlying securities in local markets and changes to the value of local currencies relative to the U.S. dollar are embedded in the investment returns. 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.

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 net of forward foreign exchange contracts amounted to $1,324,618,000, or 14 percent of total investments, at June 30, 2008, as compared to $1,271,515,000, or 14 percent of total investments, at June 30, 2007. 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 $29,373,000 and $20,575,000 at June 30, 2008 and 2007, 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 $377,025,000 and $864,179,000 at June 30, 2008 and 2007, 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 $393,361,000, or 104 percent of the fair value of the securities on loan, at June 30, 2008, as compared to $890,544,000, or 103 percent of the fair value of the securities on loan, at June 30, 2007. 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, 2008 and 2007 is summarized as follows:

(in thousands)	2008	2007
Patient care	$ 362,323	$ 310,432
Sponsored programs	66,800	75,959
State appropriations, educational and capital	78,326	28,460
Student accounts	18,383	20,145
Other	31,593	27,130
	557,425	462,126
Less provision for uncollectible accounts receivable	114,050	94,411
	$ 443,375	$ 367,715

NOTE 4 | NOTES AND PLEDGES RECEIVABLE

The composition of notes and pledges receivable at June 30, 2008 and 2007 is summarized as follows:

(in thousands)	2008	2007
Notes:		
Federal student loan programs	$ 99,464	$ 99,601
University student loan funds	18,837	17,041
Other	729	726
	119,030	117,368
Less allowance for doubtfully collectible notes	2,800	2,300
Total notes receivable, net	116,230	115,068
Gift pledges outstanding:		
Capital	137,270	148,910
Operations	77,570	72,561
	214,840	221,471
Less:		
Allowance for doubtfully collectible pledges	6,843	6,961
Unamortized discount to present value	16,823	20,045
Total pledges receivable, net	191,174	194,465
Total notes and pledges receivable, net	307,404	309,533
Less current portion	73,832	62,385
	$ 233,572	$ 247,148

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, 2008 are expected to be received in the following years ended June 30 (in thousands):

2009	$ 61,679
2010–2013	118,562
2014 and after	34,599
	$ 214,840

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 $105,467,000 and $96,360,000 at June 30, 2008 and 2007, 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.

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NOTE 5 | CAPITAL ASSETS

Capital assets activity for the years ended June 30, 2008 and 2007 is summarized as follows:

2008

(in thousands)	Beginning Balance	Additions	Retirements	Ending Balance
Land	$ 81,808	$ 7,085		$ 88,893
Land improvements	93,887	2,512		96,399
Infrastructure	164,091	21,072		185,163
Buildings	4,481,092	231,888	$ 10,036	4,702,944
Construction in progress	348,891	298,017		646,908
Equipment	1,345,544	120,039	51,268	1,414,315
Library materials	386,020	19,908		405,928
	6,901,333	700,521	61,304	7,540,550
Less accumulated depreciation	3,145,935	319,351	54,566	3,410,720
	$ 3,755,398	$ 381,170	$ 6,738	$ 4,129,830

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

The increase in construction in progress of $298,017,000 in fiscal 2008 represents the amount of capital expenditures for new projects of $472,012,000 net of capital assets placed in service of $173,995,000. The decrease in construction in progress of $208,145,000 in fiscal 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.

NOTE 6 | LONG-TERM DEBT

Long-term debt at June 30, 2008 and 2007 is summarized as follows:

(in thousands)	2008	2007
Commercial Paper:		
Tax-exempt, variable rate (1.58%)*	$ 129,825	$ 103,125
Taxable, variable rate (2.56%)*	6,760	7,075
General Revenue Bonds:		
Series 2008A, variable rate (1.60%)* through 2038	105,810	
Series 2008B, variable rate (1.50%)* to fixed via swap through 2026 and variable rate 2027 through 2028	118,335	
Series 2005A, 5.00% through 2018	34,315	37,745
unamortized premium	2,498	3,097
unamortized loss on extinguishment	(316)	(400)
Series 2005B, variable rate (1.45%)* through 2035	48,020	48,020
Series 2002, variable rate (1.40%)* to fixed via swap through 2018 and variable rate 2019 through 2032	119,900	130,090
General Revenue Refunding Bonds:		
Series 2003, 3.50% to 5.00% through 2015	29,395	34,660
unamortized premium	1,552	2,175
unamortized loss on extinguishment	(281)	(399)
Hospital Revenue Bonds:		
Series 2007A, variable rate (3.00%)* through 2038	50,120	50,120
Series 2007B, variable rate (1.45%)* through 2038	100,235	100,235
Series 2005A, variable rate (2.05%)* through 2036	69,315	69,315
Series 2005B, variable rate (1.40%)* to fixed via swap through 2026	75,065	78,085
Series 1995A, variable rate (1.40%)* through 2028	100,000	100,000
Hospital Revenue Refunding Bonds:		
Series 2002A, 5.00% to 5.25% through 2022	58,325	67,125
unamortized premium	1,279	1,747
unamortized loss on extinguishment	(2,342)	(2,700)
Series 1998A-1, 5.25% through 2011		16,540
unamortized premium		129
Series 1998A-2, variable rate (2.05%)* to fixed via swap through 2025	44,670	44,670
Series 1992A, variable rate (2.05%)* through 2020	56,000	56,000
Medical Service Plan Revenue Bonds:		
Series 1995A, variable rate (1.40%)* through 2028	48,800	49,300
Series 1991, 6.90% to 7.05% capital appreciation through 2012	7,674	9,290
Medical Service Plan Revenue Refunding Bonds:		
Series 1998A-1, variable rate (2.05%)* to fixed via swap through 2022	35,030	35,350
Housing Energy Conservation HUD Loan, 3.00% through 2021	2,233	2,372
Total long-term debt	1,242,217	1,042,766
Less current portion of long-term debt	172,939	145,148
	$ 1,069,278	$ 897,618

* Denotes rate at June 30, 2008

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, 2008 is summarized as follows:

(in thousands)	Beginning Balance	Additions	Reductions	Ending Balance
Commercial Paper:				
General revenues	$ 110,200	$ 169,625	$ 143,240	$ 136,585
Bonds and Notes:				
General revenues	254,988	224,145	19,905	459,228
Hospital revenues	581,266		28,599	552,667
Faculty Group Practice revenues	93,940	584	3,020	91,504
Student residences revenues	2,372		139	2,233
	$ 1,042,766	$ 394,354	$ 194,903	$ 1,242,217

The University maintains a combination of variable and fixed rate debt, with effective interest rates that averaged 3.40 percent in fiscal 2008 and 4.04 percent in fiscal 2007. 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 2008, the University issued $169,625,000 of commercial paper to fund new construction projects and refund Hospital Revenue Refunding Bonds Series 1998A-1. In March 2008, the University issued $224,145,000 of variable rate General Revenue Bonds. Bond proceeds were used to convert $73,200,000 of commercial paper to long-term debt and provide $150,470,000 for capital projects and $475,000 for debt issuance costs. Of the total bond issue, $105,810,000 (Series 2008A) is variable based on a daily rate mode and $118,335,000 (Series 2008B) is variable based on a weekly rate mode.

Debt obligations are generally callable by the University and mature at various dates through fiscal 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
2009	$ 172,114	$ 21,959	$ 194,073
2010	27,452	21,024	48,476
2011	29,862	20,231	50,093
2012	43,438	19,133	62,571
2013	45,956	17,656	63,612
2014-2018	207,656	73,995	281,651
2019-2023	216,909	53,838	270,747
2024-2028	243,210	32,419	275,629
2029-2033	132,815	16,992	149,807
2034-2038	120,415	5,132	125,547
	1,239,827	$ 282,379	$ 1,522,206
Plus unamortized premiums, net	2,390		
	$ 1,242,217		

* Interest on variable rate debt is estimated based on rates in effect at June 30, 2008

In connection with the Series 2008B General Revenue Bonds, the University entered into a floating-to-fixed interest rate swap agreement with a notional value covering a portion of the principal amount outstanding, $98,490,000 at June 30, 2008, and decreasing as principal on the underlying bonds is repaid. The swap agreement converts the floating variable rate on these bonds to a fixed rate of 3.105 percent until the swap terminates in April 2026. The University makes fixed rate 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 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 3.229 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 Series 2002 General Revenue Bonds, the University entered into a floating-to-fixed interest swap agreement with a notional value covering a portion of the principal amount outstanding, $58,215,000 at June 30, 2008 and 2007, and decreasing as principal on the underlying bonds is repaid. The swap agreement converts the floating variable rate on these bonds to a fixed rate of 3.5375 percent until the swap terminates in April 2018. The University makes fixed rate payments to the counterparty and receives a variable rate payment based on 68 percent of One-Month USD LIBOR through April 1, 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 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 Refunding 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 4.705 percent and 4.685 percent, respectively through December 2024 and December 2021, the final maturity dates of the underlying bonds. The University makes fixed interest payments to the counterparty and receives a variable rate payment based on the floating Bond 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 $11,612,000 at June 30, 2008 and a liability of $871,000 at June 30, 2007. 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 counterparties. 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 $650,000,000 at June 30, 2008 and $450,000,000 at June 30, 2007, were entirely unused during fiscal 2008 and 2007.

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 a rate of 6 percent.

Changes in the total reported liability for insurance and benefits obligations for the years ended June 30, 2008 and 2007 are summarized as follows:

(in thousands)	**2008**	**2007**
Balance, beginning of year	$ 141,202	$ 212,099
Claims incurred and changes in estimates	220,493	82,403
Claim payments	(219,130)	(153,300)
Balance, end of year	142,565	141,202
Less current portion	64,117	53,549
	$ 78,448	$ 87,653

NOTE 8 | POSTEMPLOYMENT BENEFITS

The University provides retiree health and welfare benefits, primarily medical, prescription drug, dental and life insurance coverage, to eligible retirees and their eligible dependents. 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. For employees retiring on or after January 1, 1987, contributions toward health and welfare benefits are shared between the University and the retiree and can vary based on date of hire, date of retirement, age and coverage elections.

The University also provides income replacement benefits, retirement savings contributions and health and life insurance benefits to substantially all permanent University employees who are enrolled in a University sponsored long-term disability plan and qualify, based on disability status while working for the University, to receive basic or expanded long-term disability benefits. Contributions toward the expanded long-term disability plan are shared between the University and employees and vary based on years of service, annual base salary and coverage elections. Contributions toward the basic long-term disability plan are paid entirely by the University.

These postemployment benefits are provided through single-employer plans administered by the University. The Executive Vice Presidents of the University have the authority to establish and amend benefit provisions of the plans.

During fiscal 2008, the University implemented GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* This Statement requires accrual-based measurement and recognition of the cost of postemployment benefits during the periods when employees render their services. Previously, the University recognized obligations for most postemployment benefits as they were paid.

The University's annual other postemployment benefits ("OPEB") cost is actuarially determined in accordance with the parameters of GASB Statement No. 45. Projections of benefits are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided and announced future changes at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point.

Changes in the total reported liability for postemployment benefits obligations for the year ended June 30, 2008 are summarized as follows:

(in thousands)	Retiree Health and Welfare	Long-term Disability	Total
Balance, beginning of year	$ 4,749	$ 82,938	$ 87,687
Annual OPEB cost:			
One-time amortization of total unfunded			
actuarially accrued liability at July 1, 2007	1,259,125	47,734	1,306,859
Recurring postemployment benefits expense	134,820	15,564	150,384
Payments of current premiums and claims	(38,519)	(14,598)	(53,117)
Balance, end of year	1,360,175	131,638	1,491,813
Less current portion	45,514	15,278	60,792
	$ 1,314,661	$ 116,360	$ 1,431,021

The OPEB balance at the beginning of the year, which totaled $87,687,000, represents a liability for open long-term disability claims and life insurance reserves, which were previously recorded at June 30, 2007 as a liability for insurance and benefit reserves. These reserves are considered postemployment benefits as defined by GASB Statement No. 45 and have been reclassified to obligations for postemployment benefits as part of the implementation of this statement.

Since a portion of retiree medical services will be provided by the University's Health System, the liability for postemployment benefit obligations is net of the related margin and fixed costs of providing those services which totaled $220,782,000 at June 30, 2008. In accordance with GASB Statement No. 45, obligations for postemployment benefits at June 30, 2008 do not reflect anticipated Medicare Part D prescription drug subsidies for future years, which would have reduced the accrued liability by $179,000,000.

The University has no obligation to make contributions in advance of when insurance premiums or claims are due for payment and currently pays for postemployment benefits on a pay-as-you-go basis. The University's obligations for postemployment benefits at June 30, 2008 as a percentage of covered payroll, of $2,311,422,000, was 65 percent.

In fiscal 2008, the University's annual OPEB cost represents the annual required contribution ("ARC"). The ARC represents a level of funding that an employer is projected to need in order to prefund its obligations for postemployment benefits over its employees' years of service. The University has chosen to amortize its initial unfunded actuarial accrued liability over one year, the minimum period allowed by GASB Statement No. 45.

At June 30, 2008, the University's OPEB liability was calculated using the projected unit credit method. Significant actuarial methods and assumptions used in the valuation are as follows:

	Retiree Health and Welfare	Long-term Disability
Discount Rate	6.4%	8.0%
Inflation Rate	3.0%	3.0%
Immediate/Ultimate Medical Trend Rate	11.7%/5.0%	11.7%/5.0%
Immediate/Ultimate Rx Trend Rate	8.5%/5.0%	8.5%/5.0%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2000 Projected to 2014	2005 SOA Life Waiver (Modified)

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, 2008 are summarized as follows:

(in thousands)	2008	2007	2006
University contributions	$ 194,962	$ 183,145	$ 171,868
Employee contributions	$ 96,015	$ 90,252	$ 84,706
Payroll covered under plan	$ 2,311,422	$ 2,172,592	$ 2,001,670
Total payroll	$ 2,444,522	$ 2,292,929	$ 2,155,752

NOTE 10 | 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 $2,920,584,000 at June 30, 2008, have been designated for academic and research programs and initiatives, and capital programs.

NOTE 11 | FEDERAL DIRECT LENDING PROGRAM

The University distributed $255,765,000 and $220,480,000 for the years ended June 30, 2008 and 2007, 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 $2,026,000 and $4,329,000 at June 30, 2008 and 2007, 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, 2008 were $1,131,102,000. Of these expenditures, approximately $15,590,000 will be funded by the State Building Authority, $140,107,000 will be funded using unexpended debt proceeds, and the remaining $975,405,000 will be funded by internal sources, gifts and 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, 2008, the University had committed, but not paid, a total of $3,334,023,000 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):

2009	$ 1,161,813
2010	729,805
2011	557,230
2012	334,799
2013	229,559
2014 and beyond	320,817
	$ 3,334,023

The University has entered into operating leases for space, which expire at various dates through fiscal 2018. Outstanding commitments for these leases are expected to be paid in the following years ended June 30 (in thousands):

2009	$ 37,332
2010	33,251
2011	28,672
2012	26,464
2013	22,963
2014–2018	67,651
	$ 216,333

Substantial amounts are received and expended by the University under federal and state programs and are subject to audit by cognizant governmental agencies. This funding relates to research, student aid, patient care and other programs. The University believes that any liabilities arising from such audits will not have a material effect on its financial position.

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.

Notes to Consolidated Financial Statements

NOTE 13 | SEGMENT INFORMATION — CONTINUED

Condensed financial information for HHC, before the elimination of certain intra-University transactions, as of and for the years ended June 30, 2008 and 2007 is as follows:

(in thousands)	2008	2007
Condensed Statement of Net Assets		
Assets:		
Current assets	$ 396,679	$ 304,711
Noncurrent assets	2,451,429	2,417,956
Total assets	$ 2,848,108	$ 2,722,667
Liabilities:		
Current liabilities	$ 161,462	$ 150,501
Noncurrent liabilities	808,195	576,017
Total liabilities	969,657	726,518
Net assets:		
Invested in capital assets, net of related debt	538,854	533,475
Restricted	73,181	69,436
Unrestricted	1,266,416	1,393,238
Total net assets	1,878,451	1,996,149
Total liabilities and net assets	$ 2,848,108	$ 2,722,667
Condensed Statement of Revenues, Expenses and Changes in Net Assets		
Operating revenues	$ 1,719,135	$ 1,561,198
Operating expenses other than depreciation expense	(1,561,044)	(1,400,029)
Depreciation expense	(122,363)	(99,476)
Operating income	35,728	61,693
Nonoperating revenues, net	97,308	239,145
Income before other revenues (expenses) and transfers	133,036	300,838
Other (expenses) revenues, net	(259,342)	5,780
Net (expenses) revenues before transfers	(126,306)	306,618
Transfers from (to) other University units, net	8,608	(74,608)
(Decrease) increase in net assets	(117,698)	232,010
Net assets, beginning of year	1,996,149	1,764,139
Net assets, end of year	$ 1,878,451	$ 1,996,149
Condensed Statement of Cash Flows		
Net cash flows provided by operating activities	$ 188,136	$ 149,799
Net cash flows provided by (used in) investing activities	92,117	(328)
Net cash flows used in capital and related financing activities	(211,183)	(104,588)
Net cash flows provided by (used in) noncapital financing activities	5,561	(70,205)
Net increase (decrease) in cash and cash equivalents	74,631	(25,322)
Cash and cash equivalents, beginning of year	82,381	107,703
Cash and cash equivalents, end of year	$ 157,012	$ 82,381

NOTE 14 | OPERATING EXPENSES BY FUNCTION

Operating expenses by functional classification for the years ended June 30, 2008 and 2007 are summarized as follows:

2008

(in thousands)	Compensation and Benefits	Supplies and Services	Depreciation	Scholarships and Fellowships	Total
Instruction	$ 676,273	$ 108,472			$ 784,745
Research	397,464	174,188			571,652
Public service	85,931	35,949			121,880
Academic support	166,489	37,148			203,637
Student services	62,365	16,343			78,708
Institutional support	124,370	41,955			166,325
Operations and maintenance of plant	40,584	208,661			249,245
Auxiliary enterprises	1,680,756	544,900			2,225,656
Depreciation			$ 319,351		319,351
Scholarships and fellowships				$ 98,847	98,847
	$ 3,234,232	$ 1,167,616	$ 319,351	$ 98,847	$ 4,820,046

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

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. In fiscal 2008, based on certain changes in net assets pursuant to the terms of the sales agreement, the sales price was reduced by $6,500,000, of which $4,500,000 is included in accrued liabilities at June 30, 2008. Subscription premiums revenue recognized by M-CARE from employers other than the University totaled approximately $196,800,000 for the six months ended December 31, 2006.