INTRODUCTION

The following discussion and analysis provides an overview of the financial position of the University of Michigan (the "University") at June 30, 2009 and 2008 and its activities for the three fiscal years ended June 30, 2009. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

The University is a comprehensive public institution of higher learning with approximately 57,000 students and 6,700 faculty members on three campuses in southeast Michigan. The University offers a diverse range of degree programs from baccalaureate to post-doctoral levels through 19 schools and colleges, and contributes to the state and nation through related research and public service programs. The University, in total, employs more than 48,000 permanent and temporary staff. The University also maintains one of the largest health care complexes in the world through its Hospitals and Health Centers ("HHC"). HHC consists of three hospitals, 40 health centers and more than 120 outpatient clinics. HHC is an integral part of the University's Health System which also includes the University's Medical School and Michigan Health Corporation, a wholly-owned corporation created to pursue joint venture and managed care initiatives.

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

FINANCIAL HIGHLIGHTS

The University's financial position remains strong, with assets of $12.9 billion and liabilities of $4.2 billion at June 30, 2009, compared to assets of $14.8 billion and liabilities of $4.0 billion at June 30, 2008. Net assets, which represent the residual interest in the University's assets after liabilities are deducted, totaled $8.7 billion at June 30, 2009 as compared to $10.8 billion at June 30, 2008. Changes in net assets represent the University's results of operations and are summarized for the years ended June 30, 2009 and 2008 as follows:

(in millions)	2009	2008
Operating revenues and state educational appropriations	$ 4,687.3	$ 4,508.6
Total expenses	5,119.3	4,853.6
	(432.0)	(345.0)
Net investment (loss) income	(1,851.2)	621.9
Gifts and other nonoperating revenues, net	195.5	287.5
	(2,087.7)	564.4
Implementation of GASB Statement No. 45, postemployment benefits obligations as of July 1, 2007		(1,306.9)
Decrease in net assets	$ (2,087.7)	$ (742.5)

Net assets decreased $2.1 billion in fiscal 2009 primarily due to net investment losses. Net assets decreased $743 million in fiscal 2008, primarily due to the implementation of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, offset by net investment income.

Operating revenues and state educational appropriations increased 4 percent, or $179 million, while total expenses increased 5 percent, or $266 million. The results of operations reflect the University's focus on maintaining its national standards academically, and in research and health care, while addressing declining state appropriations and rising health care, regulatory, and facility costs in a competitive recruitment environment for faculty and health care professionals.

Net investment losses in 2009 were $1.9 billion compared to net investment income of $622 million in 2008. The University invests its financial assets in pools with distinct risk and liquidity characteristics based on its needs, with most of its financial assets invested in two such pools. The University's working capital is primarily invested in relatively short duration, liquid assets, while the University's endowment is invested in a long term strategy where a greater allocation to equity and equity-like investments left it more exposed to the effects of the global financial crisis in 2009. The impact of losses in the endowment was muted by the University's spending policy which seeks to insulate University operations from expected volatility in the capital markets and provide for a stable and predictable level of spending from the endowment.

USING THE FINANCIAL STATEMENTS

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

STATEMENT OF NET ASSETS

The statement of net assets presents the financial position of the University at the end of the fiscal year and includes all assets and liabilities of the University. The difference between total assets and total liabilities — net assets — is one indicator of the current financial condition of the University, while the change in net assets is an indication of whether the overall financial condition has improved or worsened during the year. A comparison of the University's assets, liabilities and net assets at June 30, 2009 and 2008 is summarized as follows:

(in millions)	2009	2008
Current assets	$ 1,825	$ 2,536
Noncurrent assets:		
Endowment, life income and other investments	6,215	7,855
Capital assets, net	4,628	4,130
Other	241	250
Total assets	12,909	14,771
Current liabilities other than long-term bonds payable subject to remarketing, net	1,017	1,058
Long-term bonds payable subect to remarketing, net	652	707
Noncurrent liabilities	2,573	2,251
Total liabilities	4,242	4,016
Net assets	$ 8,667	$ 10,755

The University continues to maintain and protect its strong financial foundation. This financial health, as reflected in the statement of net assets at June 30, 2009 and 2008, results from the prudent utilization of financial resources including careful cost controls, preservation of endowment funds, conservative utilization of debt, and adherence to a long-range capital plan for the maintenance and replacement of the physical plant.

Current assets consist primarily of cash and cash equivalents, operating and capital investments, and accounts receivable. Total current assets decreased $711 million, to $1.8 billion at June 30, 2009, primarily due to decreases in cash and investments. Cash, cash equivalents and operating investments totaled $704 million at June 30, 2009, which represents approximately two months of total expenses excluding depreciation.

Current liabilities other than long-term bonds payable subject to remarketing consist primarily of accounts payable, accrued compensation, deferred revenue, commercial paper and the current portion of bonds payable.

ENDOWMENT, LIFE INCOME AND OTHER INVESTMENTS

The University's endowment, life income and other investments decreased $1.6 billion, to $6.2 billion at June 30, 2009. This decrease primarily resulted from unrealized losses on investments and endowment distributions to beneficiary units for operations, offset by the receipt of new endowment funds through gifts and transfers. The composition of the University's endowment, life income and other investments at June 30, 2009 and 2008 is summarized as follows:

(in millions)	2009	2008
Endowment investments	$ 6,001	$ 7,572
Life income investments	89	118
Noncurrent portion of insurance and benefits obligations investments	125	165
	$ 6,215	$ 7,855

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

The University uses its endowment funds to support operations in a way that strikes a balance between generating a predictable stream of annual support for current needs and preserving the purchasing power of the endowment funds for future periods. The major portion of the endowment is maintained in the University Endowment Fund, a unitized pool which represents a collection of nearly 7,000 separate (individual) funds, the majority of which are restricted for specific purposes. The University Endowment Fund is invested in the University's Long Term Portfolio, a single diversified investment pool.

The University's endowment spending rate policy provides for an annual distribution of 5 percent of the one-quarter lagged, seven-year moving average fair value of University Endowment Fund assets, with distributions limited to 5.3 percent of current fair value. Any capital gains or income generated above the endowment spending rate are reinvested so that in lean times funds will be available for distribution. Effective July 1, 2006, the moving average period was extended from three to four years and was extended by one quarter each subsequent quarter until it reached seven years at June 30, 2009. This change was enacted to further reduce distribution volatility, as well as to better preserve and grow the endowment corpus over time. In addition, departments may also use withdrawals from funds functioning as endowment to support capital expenditures and operations.

Endowment spending rate distributions totaled $244 million, $227 million and $205 million and withdrawals from funds functioning as endowment totaled $46 million, $20 million and $57 million in 2009, 2008 and 2007, respectively. Total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 5.9 percent, 4.0 percent and 5.0 percent of the fair value of the University Endowment Fund for 2009, 2008 and 2007, respectively. Over the past ten years, total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 6.5 percent.

CAPITAL AND DEBT ACTIVITIES

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

Capital asset additions totaled $844 million in 2009, as compared to $701 million in 2008. Capital asset additions primarily represent replacement, renovation and new construction of academic, research, clinical and athletic facilities, as well as significant investments in equipment, including information technology. Current year capital asset additions were primarily funded with net assets and gifts designated for capital purposes of $592 million, as well as debt proceeds of $240 million and state capital appropriations of $12 million.

In June 2009, the University completed the acquisition of the former Pfizer pharmaceutical research complex for approximately $114 million, which includes liabilities of approximately $6 million that were assumed as part of the purchase. This investment, which was funded primarily with Health System resources, provides a transformational opportunity for the University to develop and utilize the 30 buildings and 174 acres of land acquired. Known collectively as the North Campus Research Complex, these buildings with nearly 2 million square feet of sophisticated laboratory facilities and administrative space will provide much needed space for current research as well as help attract new projects and faculty to the University. This acquisition is classified as property held for future use at June 30, 2009 and committees with campus-wide representation are in the process of developing a strategy for the optimum utilization of this complex.

Construction in progress, which totaled $786 million at June 30, 2009 and $647 million at June 30, 2008, includes important new facilities for patient care, research, instruction, athletics and student residential life.

At June 30, 2009, construction continues on a new facility for C.S. Mott Children's Hospital and Women's Hospital to meet increasing patient demand and accommodate future research, education and clinical care innovations. The new state-of-the art facility will further enhance specialty services for newborns, children and pregnant women, not offered anywhere else in Michigan, including programs for Level I pediatric trauma, pediatric liver transplant, and craniofacial anomalies as well as high-risk pregnancy and specialty gynecological services. With a clinic building of nine floors and an inpatient building of twelve floors, the new facility will be approximately 1.1 million square feet. After the new facility is completed in 2012, the existing C.S. Mott Children's Hospital and Women's Hospital will be used to benefit the entire Health System.

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

A comprehensive renovation and expansion of Michigan Stadium continues. Renovation to the stadium itself will result in improvements in the number and quality of restrooms and concession stands; wider aisles, handrails and additional entry and exit points for improved crowd circulation and safety; and additional dedicated seating for fans with impaired mobility. The expansion will add 400,000 square feet encompassed by two multi-story masonry structures on both the east and west sides of the stadium, leaving the end zones open. The structures include 83 suites and approximately 3,000 club seats. Construction is taking place in the off-season so as not to interrupt the home football schedule and is expected to be completed before the 2010 season.

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

Renovation of the Stockwell Residence Hall serves to meet the contemporary and future needs of students, while preserving the building's historic character. Dining services, formerly located within the building, will be provided in the new Hill Dining Center freeing room to create meeting and community spaces for student interaction and living and learning activities. In addition, the building's infrastructure is being thoroughly upgraded, from high-speed network access to renovated bath facilities, accessibility improvements, and new plumbing, heating, cooling, ventilation, fire detection and fire suppression systems. This renovation will be completed in time for the Fall 2009 semester.

Renovation and expansion projects completed in 2009 include the Mosher-Jordan Residence Hall and Hill Dining Center, Flint Student Housing Facility, Stephen M. Ross School of Business and Alumni Memorial Hall Museum of Art.

The expansion and comprehensive renovation of the Mosher-Jordan Residence Hall provides a new dining center and preserves the existing historic areas and details, while creating new community environments by reconfiguring current spaces. A new, multi-level lobby and entrance were created to provide a single point of entry for residents and visitors, as well as centralized services for students in both houses of Mosher-Jordan. The infrastructure was upgraded to include new plumbing, elevators, heating, ventilation, fire detection and suppression systems, high-speed network access, renovated bath facilities and accessibility improvements.

The first student housing facility on the Flint Campus provides accommodations for approximately 300 students. The facility consists of one, two and four bedroom units, which include handicap accessible units. All units contain one or two bathrooms, a kitchen and living room. The first floor of the facility provides communal living and learning space for residents.

The new facility for the Stephen M. Ross School of Business encompasses 270,000 square feet that houses state-of-the-art classrooms, an auditorium and colloquiums, faculty offices, student service activities space, and a central gathering space providing seating areas and a food court.

The Museum of Art's historic home, Alumni Memorial Hall, underwent a transformative facility expansion and restoration. The expansion nearly doubled the Hall's size to address current space needs and allow for future growth in collections and programming, while the restoration addressed needed infrastructure improvements. The addition consists of three floors with a lower level and now provides space for galleries, collections, exhibitions, classrooms and administration.

The University takes its financial stewardship responsibility seriously and works hard to manage its financial resources effectively, including the prudent use of debt to finance capital projects. A strong debt rating is an important indicator of the University's success in this area. During May 2009, Moody's Investors Service, Inc. ("Moody's") affirmed its highest credit rating (Aaa) for bonds backed by a broad revenue pledge based on the University's extremely strong credit fundamentals, including significant financial resources, strong market position and consistent operating performance derived from a well diversified revenue base. Standard & Poor's Ratings Services ("Standard & Poor's") also affirmed its highest credit rating (AAA) based on the University's national reputation for excellence, strong financial resources, positive financial performance, exceptional record of fundraising, and manageable debt burden and capital plan. Only two other public universities have received the highest credit ratings from both Moody's and Standard & Poor's.

Long-term debt activity for the year ended June 30, 2009, and the type of revenue it is supported by, is summarized as follows:

(in millions)	Beginning Balance	Additions	Reductions	Ending Balance
Commercial Paper:				
General revenues	$ 137	$ 21	$ 55	$ 103
Bonds and Notes:				
General revenues	459	315	21	753
Hospital revenues	552		12	540
Faculty Group Practice revenues	92		3	89
Student residences revenues	2			2
	$ 1,242	$ 336	$ 91	$ 1,487

The University maintains a combination of fixed and variable rate debt with effective interest rates that averaged 2.2 percent in 2009 and 3.4 percent in 2008. Consistent with the University's capital and debt financing plans, total outstanding debt increased $245 million, or 20 percent, to $1.5 billion at June 30, 2009, while interest expense decreased 25 percent, to $25 million.

The University utilizes commercial paper, backed by a general revenue pledge, to provide interim financing for its capital improvement program. Outstanding commercial paper is converted to long-term debt financing, as appropriate, within the normal course of business. At June 30, 2009 and 2008, commercial paper totaled $103 million and $137 million, respectively, and is included in current liabilities. During 2009, the University issued $21 million of commercial paper to fund new construction projects.

During 2009, the University issued $307 million in fixed and variable rate general revenue bonds (Series 2009A, Series 2009B and Series 2009D) with a net original issue premium of $8 million. Bond proceeds were used to convert $51 million of commercial paper to long-term debt and provide $218 million for capital projects including the C.S. Mott Children's and Women's Hospitals, Michigan Stadium Renovation and Expansion, and North Quad Residential and Academic Complex. Bond proceeds will also be used to refund $46 million of Series 2005B general revenue bonds in July 2009, which as a result are included in the current portion of bonds payable at June 30, 2009. Of the total bond issue, $119 million is variable rate debt, $98 million is fixed rate debt and $90 million is fixed rate taxable Build America Bonds.

The University's variable rate bonds are subject to remarketing and, in accordance with GASB Interpretation No. 1, are classified as current liabilities unless supported by long-term liquidity arrangements, such as lines of credit or standby bond purchase agreements, which could refinance the debt on a long-term basis. In the event that debt is put back to the University by the debt holder, management believes that it will be remarketed within a reasonable amount of time. The University's strong credit rating facilitates the remarketing of its debt. In addition, the University maintains three remarketing agents to achieve a wide distribution of its variable rate debt. In 2009, the University experienced the failed remarketing of $47 million of its variable rate bonds, which were subsequently remarketed within ten days.

OBLIGATIONS FOR POSTEMPLOYMENT BENEFITS

The University implemented GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, during 2008. 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.

Using current actuarial assumptions, and presuming a continuation of the current level of benefits, the University's liability for postemployment benefits obligations totaled $1.56 billion and $1.49 billion at June 30, 2009 and 2008, respectively. Since a portion of retiree medical services will be provided by the University's Health System, this liability is net of the related margin and fixed costs of providing those services which totaled $199 million and $201 million at June 30, 2009 and 2008, respectively.

By implementing a series of health benefit initiatives over the past few years, the University has favorably impacted its liability for postemployment benefits obligations by $215 million. In accordance with GASB Statement No. 45, the University's liability for postemployment benefits obligations at June 30, 2009 does not reflect anticipated Medicare Part D prescription drug subsidies for future years of $143 million.

NET ASSETS

Net assets represent the residual interest in the University's assets after liabilities are deducted. The composition of the University's net assets at June 30, 2009 and 2008 is summarized as follows

(in millions)	2009	2008
Invested in capital assets, net of related debt	$ 3,276	$ 3,030
Restricted:		
Nonexpendable:		
Permanent endowment corpus	1,144	1,071
Expendable:		
Net appreciation of permanent endowments	808	1,492
Funds functioning as endowment	1,291	1,561
Restricted for operations and other	606	680
Unrestricted	1,542	2,921
	$ 8,667	$ 10,755

Net assets invested in capital assets represent the University's capital assets net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets. The $246 million increase reflects the University's continued development and renewal of its capital assets in accordance with its long-range capital plan.

Restricted nonexpendable net assets represent the historical value (corpus) of gifts to the University's permanent endowment funds. The $73 million increase primarily represents new gifts. Restricted expendable net assets are subject to externally imposed stipulations governing their use. This category of net assets includes net appreciation of permanent endowments, funds functioning as endowment and net assets restricted for operations, facilities and student loan programs. Restricted expendable net assets totaled $2.7 billion at June 30, 2009, as compared to $3.7 billion at June 30, 2008. This decrease is primarily due to investment market conditions.

Although unrestricted net assets are not subject to externally imposed stipulations, all of the University's unrestricted net assets have been designated for various academic and research programs and initiatives, as well as capital projects. At June 30, 2009 unrestricted net assets included funds functioning as endowment of $2.6 billion offset by unfunded obligations for postemployment benefits of $1.6 billion. At June 30, 2008, unrestricted net assets included funds functioning as endowment of $3.3 billion offset by unfunded obligations for postemployment benefits of $1.5 billion.

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

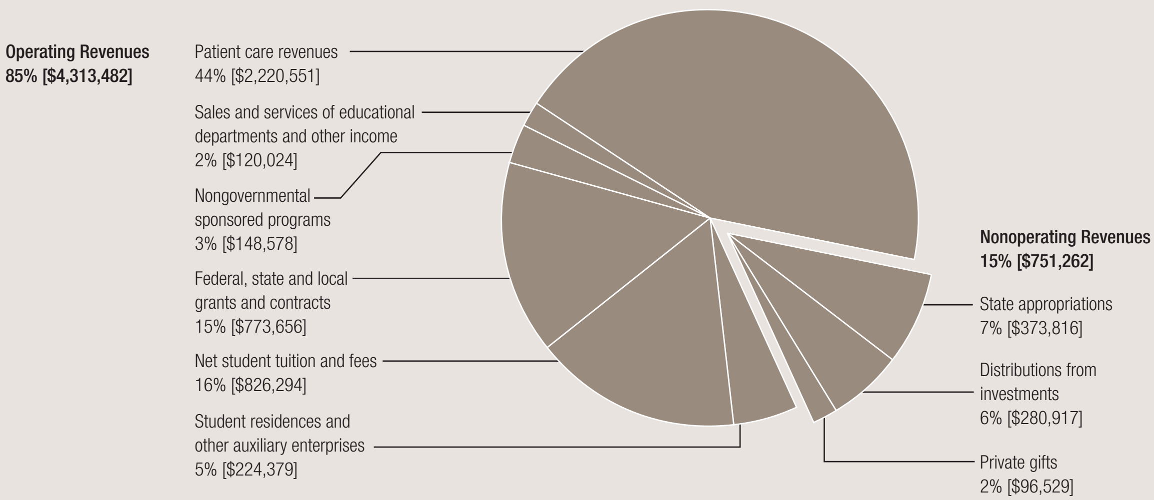
The statement of revenues, expenses and changes in net assets presents the University's results of operations. In accordance with GASB reporting principles, revenues and expenses are classified as either operating or nonoperating. A comparison of the University's revenues, expenses and changes in net assets for the three years ended June 30, 2009 is summarized as follows:

(in millions)	2009	2008	2007
Operating revenues:			
Student tuition and fees, net of scholarship allowances	$ 826.3	$ 791.2	$ 718.7
Sponsored programs	922.2	853.2	823.7
Patient care revenues and managed care premiums	2,220.6	2,105.4	1,983.6
Other	344.4	354.8	309.4
	4,313.5	4,104.6	3,835.4
Operating expenses	5,094.2	4,820.0	4,433.6
Operating loss	(780.7)	(715.4)	(598.2)
Nonoperating and other revenues (expenses):			
State educational appropriations	373.8	404.0	332.4
Private gifts for operating activities	96.5	136.7	132.8
Net investment (loss) income	(1,851.2)	621.9	1,572.6
Interest expense	(25.1)	(33.6)	(30.6)
State capital appropriations	12.2	11.8	6.4
Endowment and capital gifts and grants	88.4	160.1	137.6
Other	(1.6)	(21.1)	60.0
Nonoperating and other (expenses) revenues, net	(1,307.0)	1,279.8	2,211.2
Implementation of GASB Statement No. 45, postemployment benefits obligations as of July 1, 2007		(1,306.9)	
(Decrease) increase in net assets	(2,087.7)	(742.5)	1,613.0
Net assets, beginning of year	10,754.6	11,497.1	9,884.1
Net assets, end of year	$ 8,666.9	$ 10,754.6	$11,497.1

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

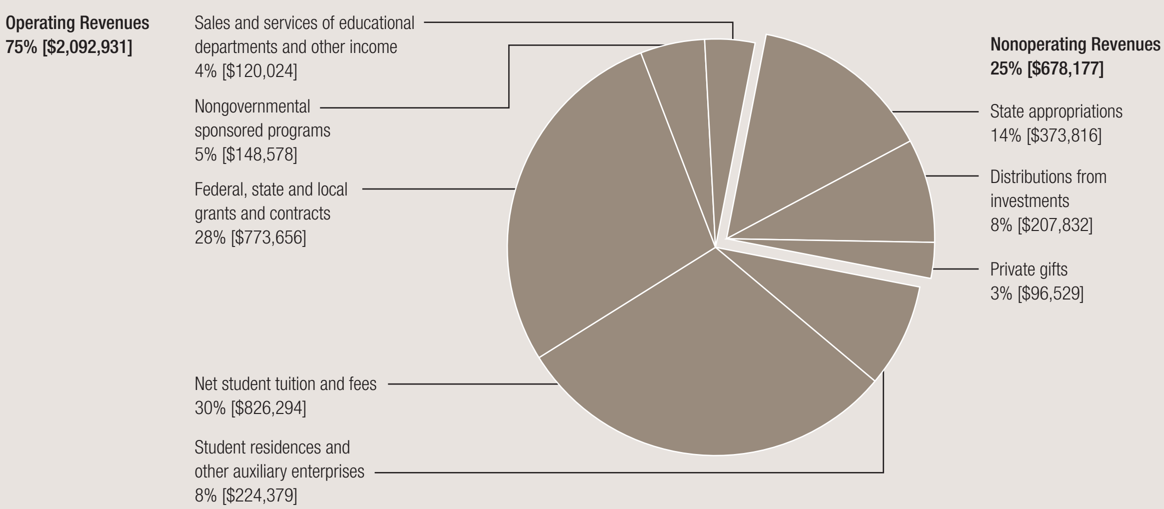
The following is a graphic illustration of revenues by source, both operating and nonoperating, which are used to fund the University's operating activities for the year ended June 30, 2009 (amounts are presented in thousands of dollars). Significant recurring sources of the University's revenues are considered nonoperating, as defined by GASB, such as state appropriations, private gifts and distributions from investments.

FISCAL YEAR 2009 REVENUES FOR OPERATING ACTIVITIES



The University measures its performance both for the University as a whole and for the University without its Health System and other similar activities. The exclusion of the Health System allows a clearer view of the operations of the schools and colleges, as well as central administration. The following is a graphic illustration of University revenues by source, both operating and nonoperating, which are used to fund operating activities other than the Health System, for the year ended June 30, 2009 (amounts are presented in thousands of dollars).

FISCAL YEAR 2009 REVENUES FOR OPERATING ACTIVITIES EXCLUDING REVENUES FROM THE UNIVERSITY'S HEALTH SYSTEM



Tuition and state appropriations are the primary sources of funding for the University's academic programs. There is a direct relationship between the growth or reduction in state support and the University's ability to restrain tuition fee increases. Together, net student tuition and fees and base state appropriations increased 3 percent, or $39 million, to $1.20 billion in 2009, as compared to 6 percent, or $70 million, to $1.16 billion in 2008.

Downturns in state of Michigan tax revenues continue to put pressure on the state budget. For the three years ended June 30, 2009, state educational appropriations revenue consisted of the following components:

(in millions)	2009	2008	2007
Base appropriations	$ 373.8	$ 370.1	$ 372.8
Net restoration (rescission)		33.9	(40.4)
	$ 373.8	$ 404.0	$ 332.4

Due to ongoing pressures and volatility in the state budget, the University's base appropriations continue to be constrained, and increased only $1 million or 0.3 percent, over the past two years. The $34 million net restoration in 2008 represents the return of part of a 2007 mid-year rescission. The $40 million mid-year rescission in 2007 consists of a reduction in base appropriations of $6 million and a deferral of $34 million until 2008.

To offset constrained base state appropriations, net student tuition and fees revenue has increased 15 percent, or $108 million, over the past two years. For the three years ended June 30, 2009, net student tuition and fees revenue consisted of the following components:

(in millions)	2009	2008	2007
Student tuition and fees	$ 1,029.2	$ 975.3	$ 891.6
Scholarship allowances	(202.9)	(184.1)	(172.9)
	$ 826.3	$ 791.2	$ 718.7

In 2009, net student tuition and fees revenue increased 4 percent, or $35 million, to $826 million, which reflects a 6 percent, or $54 million, increase in gross tuition and fee revenues offset by a 10 percent, or $19 million, increase in scholarship allowances. Tuition rate increases in 2009 were 5.6 percent for all undergraduate students on the Ann Arbor campus, with a 6.5 percent tuition rate increase for the Dearborn campus, a 5.9 percent tuition rate increase for the Flint campus and a 5 percent increase for most graduate tuition rates. The University also experienced a modest growth in the number of students.

In 2008, net student tuition and fees revenue increased 10 percent, or $73 million, to $791 million, which reflects a 9 percent, or $84 million, increase in gross tuition and fee revenues offset by a 6 percent, or $11 million, increase in scholarship allowances. Tuition rate increases in 2008 were 7.4 percent for all undergraduate students on the Ann Arbor campus, with a 7.9 percent tuition rate increase for the Dearborn campus, a 6.4 percent tuition rate increase for the Flint campus and a 5 percent increase for most graduate tuition rates. The University also experienced a modest growth in the number of students.

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

While tuition and state appropriations fund a large percentage of University costs, private support is becoming increasingly essential to the University's academic distinction. Private gifts for other than capital and permanent endowment purposes totaled $97 million in 2009, as compared to $137 million in 2008 and $133 million in 2007.

The University receives revenues for sponsored programs from various government agencies and private sources, which normally provide for both direct and indirect costs to perform these sponsored activities. Revenues for sponsored programs increased 8 percent, or $69 million, to $922 million in 2009, as compared to an increase of 4 percent, or $30 million, to $853 million in 2008. A significant portion of the University's sponsored programs revenues relate to federal research and its growth is consistent with the national trends of increasing activity after several years of stabilized federal research activity.

Patient care revenues and managed care premiums for the three years ended June 30, 2009 are summarized as follows:

(in millions)	2009	2008	2007
Patient care revenues	$ 2,220.6	$ 2,105.4	$ 1,786.8
Managed care premiums			196.8
	$ 2,220.6	$ 2,105.4	$ 1,983.6

Patient care revenues are principally generated within the University's hospitals and ambulatory care facilities under contractual arrangements with governmental payers and private insurers. Patient care revenues increased 5 percent, or $115 million, to $2.2 billion in 2009, as compared to an increase of 18 percent, or $319 million, to $2.1 billion in 2008. The increased revenues for both years primarily resulted from a growth in both outpatient and inpatient volume, as well as increased reimbursement rates from third party payers. Managed care premiums in 2007 represent subscription revenue recognized by M-CARE from contracts associated with employers other than the University. M-CARE was sold in December 2006.

Net investment loss totaled $1.9 billion in 2009, compared to net investment income of $622 million in 2008 and $1.6 billion in 2007. The financial market turmoil and wealth destruction that followed the fall of Lehman Brothers in September 2008 exceeded any since the Great Depression. This resulted in broad based losses across the University's public and private equity and equity-like investments, with the largest losses occurring in areas that had experienced the greatest gains in recent years, such as real estate, energy and other alternative investments. Despite the losses in 2009, these assets remain the University's highest performing investments over longer time periods. Fixed income investments in the University's working capital and long-term pools performed in line with expectations and proved to be a stabilizing factor on the University's overall investment portfolio.

It was also a difficult year for public equities in 2008, but the University's returns in nonmarketable limited partnerships and absolute return strategies, aided by strong returns from its energy holdings and hedging strategies, resulted in positive investment income. Prior to 2008, net investment income was primarily the result of strong performance of the University's nonmarketable limited partnerships, non-U.S. dollar equities and absolute return strategies, which provided consistent positive returns during 2007, combined with a meaningful increase in invested balances over the same time period.

The University's endowment investment policies are designed to maximize long-term total return, while its income distribution policy is designed to preserve the value of the endowment and generate a predictable stream of spendable income.

Private gifts for permanent endowment purposes totaled $60 million in 2009, as compared to $94 million in 2008 and $73 million in 2007. Capital gifts and grants totaled $28 million in 2009, as compared to $66 million in 2008 and $65 million in 2007. Over the past three years, major capital gifts have been received in support of the University's wide-ranging building initiatives, which include the Stephen M. Ross School of Business, Health System, Intercollegiate Athletics, Law School and College of Engineering.

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

A comparative summary of the University's expenses for the three years ended June 30, 2009 is as follows (amounts in millions):

(in millions)	2009		2008		2007	
Operating:						
Compensation and benefits	$ 3,390.5	66%	$ 3,234.2	67%	$ 2,961.9	66%
Supplies and services	1,255.1	24	1,167.6	24	1,103.9	25
Depreciation	341.5	7	319.4	6	284.1	6
Scholarships and fellowships	107.1	2	98.8	2	83.7	2
	5,094.2	99	4,820.0	99	4,433.6	99
Nonoperating:						
Interest	25.1	1	33.6	1	30.6	1
	$ 5,119.3	100%	$ 4,853.6	100%	$ 4,464.2	100%

The University is committed to recruiting and retaining outstanding faculty and staff and the compensation package is one way to successfully compete with peer institutions and nonacademic employers. The resources expended for compensation and benefits increased 5 percent, or $156 million, to $3.4 billion in 2009, as compared to a 9 percent increase, or $272 million, to $3.2 billion in 2008. Of this 2008 increase, $97 million represents additional operating expenses with the implementation of GASB Statement No. 45.

Health care benefits are one of the most significant employee benefits and over the past several years, the University has implemented several initiatives to better control its rate of increase, encourage employees to choose the lowest cost insurance plan that meets their needs and share with employees a small portion of health insurance cost increases.

The University utilizes a single pharmacy benefit administrator to manage all pharmacy benefits with University oversight. The University also actively promotes and manages generic drug utilization and has achieved a 71 percent generic dispensing rate in 2009, as compared to 68 percent in 2008 and 60 percent in 2007. In January 2006, the University unbundled pharmacy benefit claim processing and mail order services and selected separate vendors for each service to achieve better discounts for retail and mail order pricing arrangements and additional rebates.

Compared to most employers, the University is in an unique position to utilize internal experts to advise and guide its health care and drug plans. For example, the University utilizes a Pharmacy Benefits Advisory Committee, which consists of internal experts such as Health System physicians, School of Pharmacy faculty and an on-staff pharmacist, to monitor the safety and effectiveness of covered medications as well as to optimize appropriate prescribing, dispensing and cost effective use of prescription drugs.

The University's MHealthy initiative is a campus-wide effort to encourage healthier living through increased activity, attention to physical safety in the workplace, and other health and wellness efforts. The health and wellness programs offered by the University through this initiative have resulted in greater integration of evidence-based wellness programming into the University's benefit programs.

Over the past several years, MHealthy has offered a broad spectrum of programs designed to support healthy lifestyles. For example, the Focus on Medicines program offers employees, retirees and dependents taking seven or more prescription medications a comprehensive medication review with a University pharmacist to optimize treatment and reduce drug interaction risks. The Focus on Diabetes program reduces or eliminates co-pays for selected medications for employees and dependents who have diabetes to encourage the proper and sustained use of specific drugs that help manage their diabetes and to help prevent or reduce the long-term complications of the disease.

During 2009, MHealthy completed the first university-wide health risk assessment, with more than 17,500 faculty and staff completing an online health risk questionnaire and participating in a wellness screening at sites throughout the University. Data gathered from this assessment will be used to design programs to address the greatest areas of community health risk and thereby reduce the costs incurred by the University.

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

Supplies and services expenses increased 7 percent, or $88 million, to $1.3 billion in 2009, as compared to an increase of 6 percent, or $64 million, to $1.2 billion in 2008. The increases in 2009 and 2008 are primarily due to increases in patient activity experienced by the Health System, sponsored research activity and utilities.

In addition to their natural (object) classification, it is also informative to review operating expenses by function. A comparative summary of the University's expenses by functional classification for the three years ended June 30, 2009 is as follows (amounts in millions):

	2009		2008		2007	
Operating:						
Instruction	$ 820.3	16%	$ 784.7	16%	$ 727.3	16%
Research	622.6	12	571.7	12	540.6	12
Public service	126.5	2	121.9	2	103.9	2
Institutional and academic support	485.2	10	448.7	9	378.7	9
Auxiliary enterprises:						
Patient and managed care	2,164.5	42	2,046.0	42	1,860.6	42
Other	148.6	3	179.6	4	198.5	4
Operations and maintenance of plant	277.9	5	249.2	5	256.3	6
Depreciation	341.5	7	319.4	7	284.0	6
Scholarships and fellowships	107.1	2	98.8	2	83.7	2
	5,094.2	99	4,820.0	99	4,433.6	99
Nonoperating:						
Interest	25.1	1	33.6	1	30.6	1
	$ 5,119.3	100%	$ 4,853.6	100%	$ 4,464.2	100%

Instruction and public service expenses increased 4 percent, or $40 million, to $947 million in 2009, as compared to 9 percent, or $75 million, to $907 million in 2008. These increases are consistent with the small level of growth in the related revenue sources, as well as the implementation of GASB Statement No. 45, which increased instruction and public service expenses by 2 percent in 2008.

To measure its total volume of research expenditures, the University considers research expenses, included in the above table, as well as research related facilities and administrative expenses, research initiative and start-up expenses, and research equipment purchases. These amounts aggregated $1.017 billion in 2009, as compared to $929 million in 2008 and $881 million in 2007. This represents an increase of 15 percent, or $136 million, from 2007 to 2009, which includes the impact of the implementation of GASB Statement No. 45, which increased the total volume of research expenditures by 2 percent in 2008.

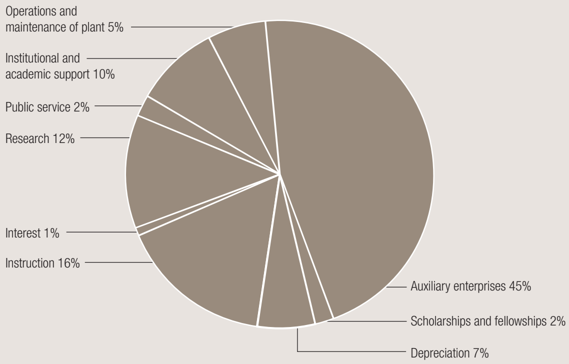
Patient and managed care expenses increased 6 percent, or $119 million, to $2.2 billion in 2009, as compared to a 10 percent, or $185 million increase in 2008. The increases in 2009 and 2008 are the result of increased patient activity, including costs of medical supplies and pharmaceuticals. The increase in 2008 as compared to 2007 also reflects the implementation of GASB Statement No. 45, offset by the sale of M-CARE effective December 31, 2006.

Total scholarships and fellowships provided to students aggregated $327 million in 2009, as compared to $300 million in 2008 and $272 million in 2007, an increase of 20 percent over the past two years. Tuition, housing and fees revenues are reported net of aid applied to students' accounts, while amounts paid directly to students are reported as scholarship and fellowship expense. Scholarships and fellowships for the three years ended June 30, 2009 are summarized as follows:

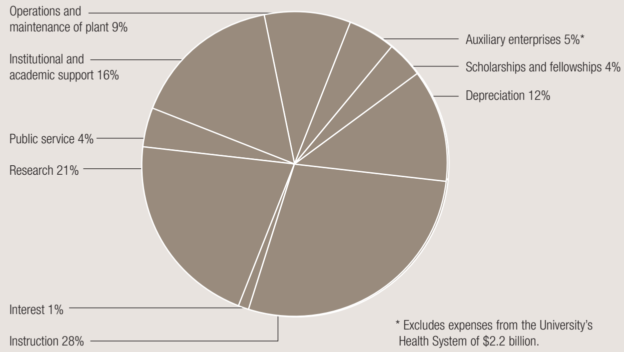
(in millions)	2009	2008	2007
Paid directly to students	$ 107.1	$ 98.8	$ 83.7
Applied to tuition and fees	202.9	184.1	172.9
Applied to University Housing	16.5	16.7	15.7
	$ 326.5	$ 299.6	$ 272.3

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

FISCAL YEAR 2009 EXPENSES BY FUNCTION



FISCAL YEAR 2009 EXPENSES BY FUNCTION EXCLUDING EXPENSES FROM THE UNIVERSITY'S HEALTH SYSTEM



* Excludes expenses from the University's Health System of $2.2 billion.

STATEMENT OF CASH FLOWS

The statement of cash flows provides additional information about the University's financial results by reporting the major sources and uses of cash. A comparative summary of the statement of cash flows for the years ended June 30, 2009 and 2008 is as follows:

(in millions)	2009	2008
Cash received from operations	$ 4,335.2	$ 4,109.3
Cash expended for operations	(4,699.3)	(4,391.7)
Net cash used in operating activities	(364.1)	(282.4)
Net cash provided by investing activities	256.1	189.6
Net cash used in capital and related financing activities	(575.0)	(478.6)
Net cash provided by noncapital financing activities	546.3	585.0
Net (decrease) increase in cash and cash equivalents	(136.7)	13.6
Cash and cash equivalents, beginning of year	495.1	481.5
Cash and cash equivalents, end of year	$ 358.4	$ 495.1

Cash received from operations primarily consists of student tuition, sponsored program grants and contracts, and patient care revenues. Significant sources of cash provided by noncapital financing activities, as defined by GASB, include state appropriations and private gifts used to fund operating activities. Cash and cash equivalents decreased $137 million in 2009, as compared to an increase of $14 million in 2008.

ECONOMIC FACTORS THAT WILL AFFECT THE FUTURE

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

A crucial element to the University's future continues to be our strong relationship with the state of Michigan. Historically, there has been a direct relationship between the growth or reduction of state support and the University's ability to control tuition increases, as reduced growth in state appropriations generally necessitates increased tuition levels. In adopting the the budget for 2010, the University anticipated a 3 percent decrease in state educational appropriations. To support the University's commitment to both academic excellence and accessibility, the University's budget for 2010 includes a moderate increase in tuition rates along with an increased investment in financial aid for undergraduates. Based on state revenue forecasts, the University is also preparing for further declines in state support for higher education in 2011 and beyond.

The University continues to execute its long-range plan to modernize and expand its complement of older facilities while adding key new facilities for instruction, research, patient care, and residential life. This strategy addresses the University's growth and the continuing effects of technology on teaching and research methodologies. Authorized costs to complete construction and other projects totaled $1.17 billion at June 30, 2009. Funding for these projects is anticipated to include $1.04 billion from gifts and net assets designated for capital purposes as well as future borrowings, $126 million from the utilization of unexpended debt proceeds and $4 million from the State Building Authority. While the State continues to support the University's systematic renewal of core academic facilities, economic pressures may also affect the State's future support.

The University is developing a strategy for the optimum utilization of the newly acquired North Campus Research Complex, which is classified as property held for future use at June 30, 2009. This investment is expected to result in significant economic benefits for both the University and the surrounding region by making strategic use of University resources, and strengthening Michigan's life sciences industry. When fully developed this complex could enable the University to create up to 3,000 new faculty and staff positions over the next ten years.

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

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

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

After careful review by top clinical and health policy faculty and financial experts, the University announced a new health benefits cost sharing program which will be phased in over two years, commencing January 1, 2010. Once fully implemented, the University's overall contribution toward the health care of employees, retirees and dependents will be 70 percent of the total cost of premiums, co-pays and deductibles. Down from the current 80 percent overall contribution, the new target is more in line with average contributions of peer universities and health systems. The percentage applied to each individual depends on the plan choice and whether dependents are covered. Under the new structure, contribution amounts will be based on salary bands which are designed to lessen the impact on lower paid employees and retirees. In addition, the University's health premium contribution for part-time employees working between 20 and 31 hours per week will be reduced to 80 percent of the contribution made for full-time staff in the lowest salary band. Once fully implemented in 2011, these changes are expected to reduce the University's annual health care expenses by approximately $31 million. Beginning January 1, 2010, newly hired faculty and staff will also be subject to a one year waiting period before receiving the University's ten percent retirement savings plan contribution. This change is expected to result in annual savings of $11 million.

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