MANAGEMENT'S DISCUSSION AND ANALYSIS *(Unaudited)*

Introduction

The following discussion and analysis provides an overview of the financial position of the University of Michigan (the "University") at June 30, 2010 and 2009 and its activities for the three fiscal years ended June 30, 2010. 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 58,000 students and 6,900 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 41,000 permanent employees and 11,000 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 $13.7 billion and liabilities of $4.3 billion at June 30, 2010, compared to assets of $12.9 billion and liabilities of $4.2 billion at June 30, 2009. Net assets, which represent the residual interest in the University's assets after liabilities are deducted, totalled $9.4 billion at June 30, 2010 as compared to $8.7 billion at June 30, 2009. Changes in net assets represent the University's results of operations and are summarized for the years ended June 30, 2010 and 2009 as follows:

(in millions)	2010	2009
Operating revenues and educational appropriations	$ 5,010.5	$ 4,687.3
Total operating and net interest expenses	5,306.8	5,119.3
	(296.3)	(432.0)
Net investment income (loss)	796.4	(1,851.9)
Gifts and other nonoperating revenues, net	198.3	195.5
Increase (decrease) in net assets	$ 698.4	$ (2,088.4)

Net assets increased $698 million in fiscal 2010, primarily due to net investment income which totalled $796 million. Net assets decreased $2.1 billion in fiscal 2009, primarily due to net investment losses which totalled $1.9 billion.

The results of operations reflect the University's focus on maintaining its national standards academically, and in research and health care, while addressing declining base state appropriations and rising health care, regulatory, and facility costs in a competitive recruitment environment for faculty and health care professionals. Operating revenues and educational appropriations increased 7 percent, or $323 million, due primarily to increases in federal grants and patient care revenues. Total operating and net interest expenses increased 4 percent, or $188 million, which reflects increases in patient care and sponsored research activities, offset by aggressive cost cutting and productivity gains.

Net investment income totalled $796 million in 2010, as compared to net investment losses of $1.9 billion in 2009. 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 endowment investment activities is 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.

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, 2010 and 2009 is summarized as follows:

(in millions)	2010	2009
Current assets	$ 1,685	$ 1,825
Noncurrent assets:		
Endowment, life income and other investments	6,807	6,215
Capital assets, net	4,956	4,627
Other	268	265
Total assets	13,716	12,932
Current liabilities	1,346	1,669
Noncurrent liabilities	3,007	2,598
Total liabilities	4,353	4,267
Net assets	$ 9,363	$ 8,665

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, 2010 and 2009, 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 $140 million, to $1.7 billion at June 30, 2010, primarily due to decreases in cash and investments. Cash, cash equivalents and operating investments totalled $767 million at June 30, 2010, which represents approximately two months of total expenses excluding depreciation.

Current liabilities consist primarily of accounts payable, accrued compensation, deferred revenue, commercial paper, the current portion of bonds payable and net long-term bonds payable subject to remarketing. Current liabilities decreased $323 million, to $1.3 billion at June 30, 2010, primarily due to a decrease in net long-term bonds payable subject to remarketing. The variable rate portion of bonds payable has remarketing features which allow bondholders to put debt back to the University and is, accordingly, classified as a current liability unless supported by long-term liquidity agreements which can refinance the debt on a long-term basis.

Endowment, Life Income and Other Investments

The University's endowment, life income and other investments increased $592 million, to $6.8 billion at June 30, 2010. This increase primarily resulted from unrealized gains on investments and the receipt of new endowment funds through gifts and transfers, offset by endowment distributions to beneficiary units for operations. The composition of the University's endowment, life income and other investments at June 30, 2010 and 2009 is summarized as follows:

(in millions)	2010	2009
Endowment investments	$ 6,564	$ 6,001
Life income investments	94	89
Noncurrent portion of insurance and benefits obligations investments	149	125
	$ 6,807	$ 6,215

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 approximately 7,100 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. In addition, departments may also use withdrawals from funds functioning as endowment to support capital expenditures and operations.

Endowment spending rate distributions totalled $255 million, $244 million and $227 million and withdrawals from funds functioning as endowment totalled $5 million, $46 million and $20 million in 2010, 2009 and 2008, respectively. Total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 5.1 percent, 5.9 percent and 4.0 percent of the current year average fair value of the University Endowment Fund for 2010, 2009 and 2008, respectively. Over the past ten years, total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 5.8 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 totalled $695 million in 2010, as compared to $844 million in 2009. Capital asset additions primarily represent replacement, renovation and new construction of academic, research, clinical, athletic and student residence 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 $521 million, as well as debt proceeds of $172 million and state capital appropriations of $2 million.

Construction in progress, which totalled $546 million at June 30, 2010 and $786 million at June 30, 2009, includes important new facilities for patient care, research, instruction, athletics and student residential life.

At June 30, 2010, construction continues on a new facility for C.S. Mott Children's Hospital and Von Voigtlander 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 fiscal 2012, the existing C.S. Mott Children's Hospital and Women's Hospital will be used to benefit the entire Health System.

Construction projects are also underway at the Law School. Legal education has changed considerably since Hutchins Hall, the main classroom and administrative building for the Law School, opened in 1933. Today's law students take a greater number of small classes, interact more with each other and with clients in supervised clinical settings, and draw heavily on technology. Located across Monroe Street and south of the Law Quad, a new four-story academic and administrative building is under construction to meet these needs, as well as provide more space for a student body which has more than doubled since the last time the Law School added classroom space. In addition, the new, two-level Robert B. Aikens Commons will occupy the currently unused grassy area between Hutchins Hall and the Legal Research Building. This structure will include a main floor café and a lower level designed to facilitate student meetings and study groups. This project also includes life safety upgrades to Hutchins Hall and the Cook Library. These projects are scheduled to be completed in fiscal 2012.

The renovation of Couzens Residence Hall serves to meet the contemporary and future needs of students, by thoroughly updating the building's infrastructure while preserving its traditional design. New and reorganized spaces within the facility will revitalize the old residence hall and create spaces for living-learning and academic initiatives, student interaction, and creation of community. The building's infrastructure will also be 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. In addition, energy conservation measures will be implemented to improve the energy performance of the overall building. This renovation, scheduled to be completed in Spring 2011, is part of the University's residential life initiatives and follows deep renovations to Mosher Jordan and Stockwell residence halls in previous years.

Expansion and renovation projects completed in 2010 include Brehm Tower, North Quad Residential and Academic Complex, Stockwell Residence Hall and Michigan Stadium.

Brehm Tower provides a new state-of-the art eye center that more than doubles capacity for eye care, research and education, as well as provides scientists more space to search for a cure for Type 1 diabetes. This new facility, which is connected to the current Kellogg Eye Center Tower includes eight floors for clinics, surgery and research, serving 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 allow natural light to fill the clinics and common space, of particular benefit to patients whose vision is impaired. The Tower's clinics have space for patient education and comfortable waiting areas designed to aid patient flow. Research areas feature open laboratories to encourage collaboration and provide flexibility as research projects grow. The new facility also houses the Brehm Center for Type 1 Diabetes Research and Analysis, which provides significant opportunities for collaboration among diabetes and vision scientists, particularly on vision loss caused by diabetes.

Construction of the first new student residence hall on the Ann Arbor campus in more than 40 years was completed this summer. The North Quad Residential and Academic Complex combines sophisticated classroom and academic space with residence space for 460 students. This results in 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, social and programmatic needs. The academic space will provide classrooms, studios and offices for five information and communications-related university programs.

The comprehensive renovation of Stockwell Residence Hall, which was completed in Fall 2009, meets the contemporary and future needs of students, while preserving the building's historic character. The building's infrastructure was 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. In addition, because dining services formerly located within the building are now provided in the new Hill Dining Center, space was available for the creation of meeting and community spaces for student interaction and living and learning activities.

A comprehensive renovation and expansion of Michigan Stadium was finished in time for the start of the 2010-11 football season. Renovation to the stadium itself resulted 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 added 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. These structures include 83 suites and approximately 3,000 club seats.

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 nearly 174 acres of land acquired. Known collectively as the North Campus Research Complex ("NCRC"), these buildings with nearly 2 million square feet of sophisticated laboratory facilities and administrative space will provide much needed space to help attract new research funding and faculty to the University.

During 2010, $30 million of the acquired NCRC property was placed in service, including administrative and utility buildings and a 300-space parking lot at the southern end of the property open to university commuters. The first phase of administrative building occupancy encompassed groups involved in supporting research and approximately 300 current employees were moved into four office buildings in the complex. These office-related functions were readily moved, primarily from leased space, into the NCRC with minimal improvements to the facilities. Other property in the complex, especially laboratories, has longer commissioning and activation timelines and will be the focus of occupancy efforts in 2011 and beyond. The unoccupied portion of the NCRC is classified as property held for future use and totalled $84 million at June 30, 2010. A small, dedicated NCRC staff is moving forward with implementation of the research growth plans developed in 2010, which will involve research groups from multiple schools and colleges across the university.

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 December 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.

The University maintains a combination of fixed and variable rate debt, which totalled $1.5 billion at June 30, 2010. Long-term debt activity for the year ended June 30, 2010, 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	$ 102	$ 8	$ 23	$ 87
Bonds and Notes:				
General revenues	754	365	69	1,050
Hospital revenues	540		240	300
Faculty Group Practice revenues	89		24	65
Student residences revenues	2			2
	$ 1,487	$ 373	$ 356	$ 1,504

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, 2010 and 2009, commercial paper totalled $87 million and $102 million, respectively, and is included in current liabilities.

Consistent with capital and debt financing plans, the University issued fixed rate general revenue bonds in 2010 to refund variable rate debt supported by specific lines of revenue and support capital projects. Total bond proceeds of $365 million, which included a net original issue premium of $18 million, were utilized to refund variable rate hospital and medical service plan revenue supported bonds of

$201 million as well as provide $164 million for capital projects and debt issuance costs. In addition, the University refunded $46 million of variable rate Series 2005B General Revenue Bonds in 2010, utilizing a portion of proceeds from the Series 2009A (fixed rate) and Series 2009B (variable rate) General Revenue Bonds issued in 2009, and extinguished $56 million of variable rate Series 1992A Hospital Revenue Refunding Bonds.

The University continues to increase its mix of fixed rate bonds relative to variable rate demand bonds. While fixed rate bonds typically have a higher effective rate of interest as compared to variable rate demand bonds, they are subject to less volatility from liquidity and interest rate perspectives. The University's fixed and variable rate debt as of June 30, 2010 and 2009 is summarized as follows:

(in millions)	2010	2009
Variable rate:		
Commercial paper	$ 87	$ 102
Demand bonds	760	1,075
Fixed rate bonds	657	310
	$ 1,504	$ 1,487

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.

Interest expense net of federal subsidies received for interest on taxable Build America Bonds and interest capitalized during construction increased 6 percent, to $27 million in 2010. The University maintains a combination of variable and fixed rate debt, with effective interest rates that averaged approximately 2 percent in 2010 and 2009, including the amortization of bond premiums and discounts and net of federal subsidies for interest on taxable Build America Bonds.

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 obligations for postemployment benefits totalled $1.61 billion and $1.56 billion at June 30, 2010 and 2009, 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 totalled $199 million and $201 million at June 30, 2010 and 2009, respectively.

By implementing a series of health benefit initiatives over the past few years, the University has favorably impacted its obligations for postemployment benefits by $281 million. In accordance with GASB Statement No. 45, the University's obligations for postemployment benefits at June 30, 2010 do not reflect anticipated Medicare Part D prescription drug subsidies for future years of $179 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, 2010 and 2009 is summarized as follows:

(in millions)	2010	2009
Invested in capital assets, net of related debt	$ 3,503	$ 3,276
Restricted:		
Nonexpendable:		
Permanent endowment corpus	1,214	1,144
Expendable:		
Net appreciation of permanent endowments	924	808
Funds functioning as endowment	1,447	1,291
Restricted for operations and other	439	606
Unrestricted	1,836	1,540
	$ 9,363	$ 8,665

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 $227 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 $70 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 totalled $2.8 billion at June 30, 2010, as compared to $2.7 billion at June 30, 2009.

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. Unrestricted net assets at June 30, 2010 and 2009 totalled $1.8 billion and $1.5 billion, respectively. At June 30, 2010, unrestricted net assets included funds functioning as endowment of $2.9 billion offset by unfunded obligations for postemployment benefits of $1.6 billion. 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. Unrestricted net assets at June 20, 2010 and 2009 also included other net resources of $500 million.

Statement of Revenues, Expenses and Changes in Net Assets

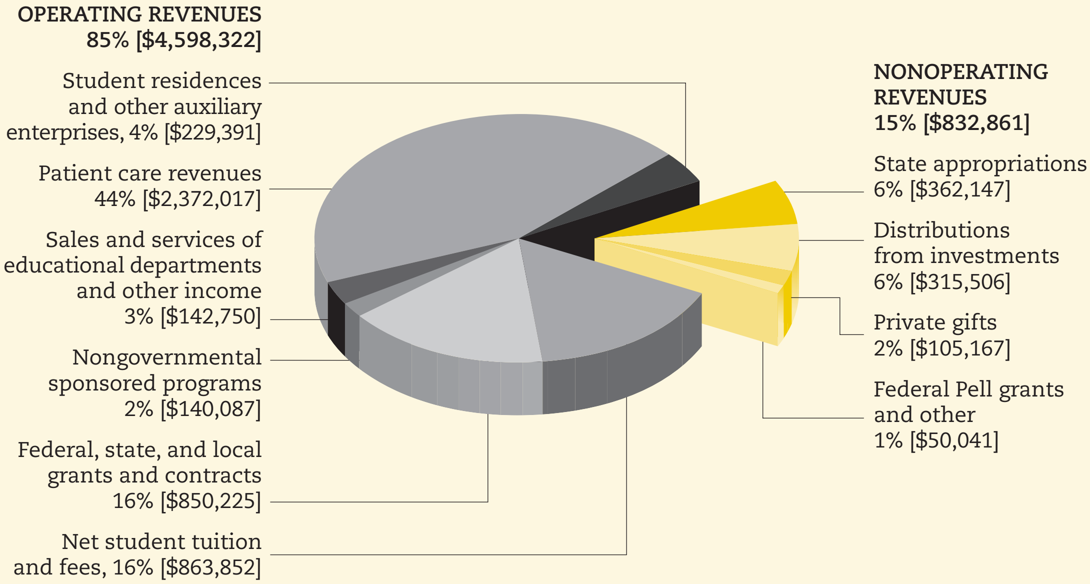
The statement of revenues, expenses and changes in net assets presents the University's results of operations. In accordance with GASB reporting principles, revenues and expenses are classified as either operating or nonoperating. A comparison of the University's revenues, expenses and changes in net assets for the three years ended June 30, 2010 is summarized as follows:

(in millions)	2010	2009	2008
Operating revenues:			
Student tuition and fees, net of scholarship allowances	$ 863.9	$ 826.3	$ 791.2
Sponsored programs	990.3	897.3	832.5
Patient care revenues	2,372.0	2,220.6	2,105.4
Other	372.2	344.4	354.8
	4,598.4	4,288.6	4,083.9
Operating expenses	5,280.1	5,094.2	4,820.0
Operating loss	(681.7)	(805.6)	(736.1)
Nonoperating and other revenues (expenses):			
State educational appropriations	362.1	373.8	404.0
State fiscal stabilization funds	10.1		
Federal Pell grants	39.9	24.9	20.7
Private gifts for operating activities	105.2	96.5	136.7
Net investment income (loss)	796.4	(1,851.9)	620.2
Interest expense	(30.0)	(25.1)	(33.6)
Federal subsidies for interest on Build America Bonds	3.3		
State capital appropriations	2.0	12.2	11.8
Endowment and capital gifts and grants	88.7	88.4	160.1
Other	2.4	(1.6)	(21.0)
Nonoperating and other revenues (expenses), net	1,380.1	(1,282.8)	1,298.9
Implementation of GASB Statement No. 45, postemployment benefits obligations as of July 1, 2007			(1,306.9)
Increase (decrease) in net assets	698.4	(2,088.4)	(744.1)
Net assets, beginning of year	8,664.6	10,753.0	11,497.1
Net assets, end of year	$ 9,363.0	$ 8,664.6	$ 10,753.0

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.

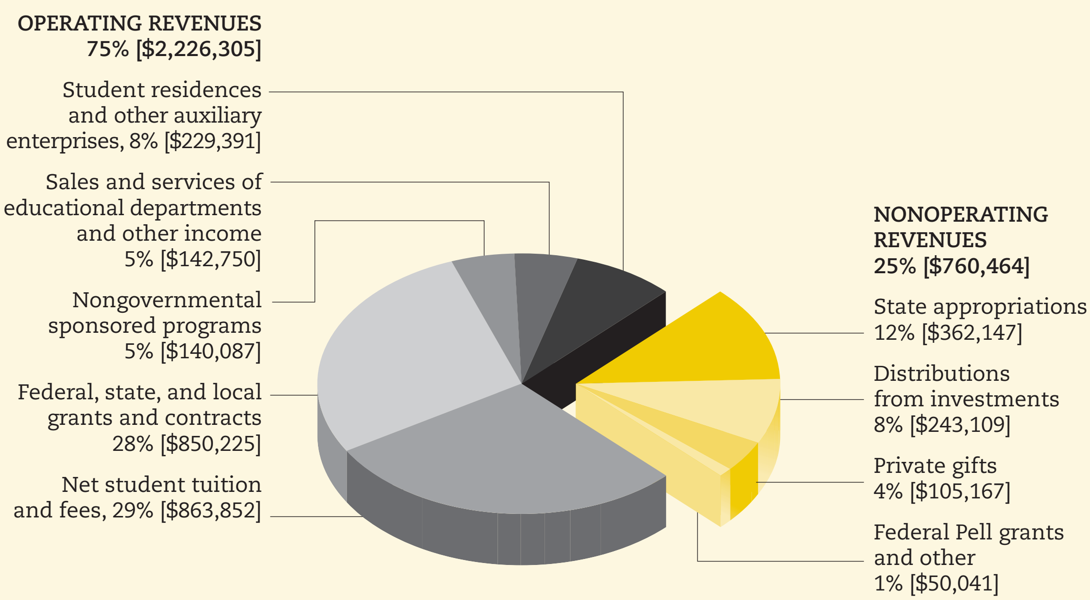
The following is a graphic illustration of revenues by source, both operating and nonoperating, which are used to fund the University's operating activities for the year ended June 30, 2010 (amounts are presented in thousands of dollars). Significant recurring sources of the University's revenues are considered nonoperating, as defined by GASB, such as state appropriations, distributions from investments, private gifts, and federal Pell grants.

Fiscal Year 2010 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, 2010 (amounts are presented in thousands of dollars).

Fiscal Year 2010 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 2 percent, or $26 million, to $1.23 billion in 2010, as compared to 3 percent, or $39 million, to $1.20 billion in 2009.

Downturns in state of Michigan tax revenues continue to put pressure on the state budget. For the three years ended June 30, 2010, state educational appropriations revenue consisted of the following components:

(in millions)	2010	2009	2008
Base appropriations	$ 362.1	$ 373.8	$ 370.1
Net restoration			33.9
	$ 362.1	$ 373.8	$ 404.0

Due to ongoing pressures and volatility in the state budget, the University's base appropriations continue to be constrained, decreasing $8 million or 2 percent, over the past two years. The $34 million net restoration in 2008 represents the return of part of a 2007 mid-year rescission, which totalled $40 million.

To maintain academic excellence and offset constrained base state appropriations, net student tuition and fees revenue increased 9 percent, or $73 million, over the past two years. For the three years ended June 30, 2010, net student tuition and fees revenue consisted of the following components:

(in millions)	2010	2009	2008
Student tuition and fees	$ 1,097.5	$ 1,029.2	$ 975.3
Scholarship allowances	(233.6)	(202.9)	(184.1)
	$ 863.9	$ 826.3	$ 791.2

In 2010, net student tuition and fees revenue increased 5 percent, or $38 million, to $864 million, which reflects a 7 percent, or $68 million, increase in gross tuition and fee revenues offset by a 15 percent, or $31 million increase in scholarship allowances. Tuition rate increases in 2010 were 5.6 percent for all undergraduate and most graduate students on the Ann Arbor campus, with a 6.7 percent tuition rate increase for all undergraduates and 3.1 percent increase for most graduate students on the Dearborn campus, and a 6.5 percent tuition rate increase for most undergraduate students on the Flint campus. The University also experienced a modest growth in the number of students on all three campuses.

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.

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.

In 2010, the University received $10 million from the State Fiscal Stabilization Fund program, a one-time appropriation under the American Recovery and Reinvestment Act of 2009. The U. S. Department of Education awarded state governors funds in exchange for a commitment to advance essential education reforms to benefit students from early learning through post-secondary education, including college. These funds were also awarded to help stabilize state and local government budgets in order to minimize and avoid reductions in education and other essential public services. The University used its $10 million allocation in 2010 to provide financial aid to resident students.

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 totalled $105 million in 2010, as compared to $97 million in 2009 and $137 million in 2008.

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 12 percent, or $108 million, to $1.0 billion in 2010, as compared to an increase of 8 percent, or $69 million, to $922 million in 2009. 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. The increase in federal support for sponsored programs in 2010 was especially fueled by federal stimulus funds from the American Recovery and Reinvestment Act of 2009. Revenues earned from federal stimulus funds for sponsored programs totalled $60 million in 2010, with $58 million specifically for research.

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 7 percent, or $151 million, to $2.4 billion in 2010, as compared to an increase of 5 percent, or $115 million, to $2.2 billion in 2009. 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.

Net investment income totalled $796 million in 2010, compared to net investment loss of $1.9 billion in 2009 and net investment income of $622 million in 2008. Financial markets rebounded strongly in 2010 from the losses in the prior year, with most asset classes experiencing double digit positive returns. The real estate segment of the University's investment portfolio, however, continued to experience losses in 2010. Real estate investments represented 11 percent and 12 percent of the University's total investments at June 30, 2010 and 2009, respectively.

In 2009, the financial market turmoil that followed the banking crisis in 2008 resulted in broad 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.

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 totalled $60 million in 2010, as compared to $61 million in 2009 and $94 million in 2008. Capital gifts and grants totalled $29 million in 2010, as compared to $28 million in 2009 and $66 million in 2008. 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, 2010 is as follows (amounts in millions):

	2010		2009		2008	
Operating:						
Compensation and benefits	$ 3,529.3	66%	$ 3,390.5	66%	$ 3,234.2	67%
Supplies and services	1,276.9	24	1,255.1	24	1,167.6	24
Depreciation	360.1	7	341.5	7	319.4	6
Scholarships and fellowships	113.8	2	107.1	2	98.8	2
	5,280.1	99	5,094.2	99	4,820.0	99
Nonoperating:						
Interest, net	26.7	1	25.1	1	33.6	1
	$ 5,306.8	100%	$ 5,119.3	100%	$ 4,853.6	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 non-academic employers. The resources expended for compensation and benefits increased 4 percent, or $139 million, to $3.5 billion in 2010, as compared to a 5 percent, or $156 million increase, to $3.4 billion in 2009.

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

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 including 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 also actively promotes and manages generic drug utilization and has achieved a 72 percent generic dispensing rate in 2010, as compared to 71 percent in 2009 and 68 percent in 2008.

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. During 2010, MHealthy completed the second university-wide health risk assessment, with more than 15,000 faculty and staff completing an online health risk questionnaire. 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.

Effective January 1, 2010, after careful review by the University's nationally recognized health policy faculty and financial experts, the University commenced a new health benefits cost sharing program which is being phased in over two years. 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 from 100 percent 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 are 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.

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 2 percent, or $22 million, to $1.3 billion in 2010, as compared to an increase of 7 percent, or $88 million, to $1.3 billion in 2009. The increases in 2010 and 2009 are primarily due to increases in patient care and sponsored research activities offset by aggressive cost cutting and productivity gains.

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, 2010 is as follows (amounts in millions):

	2010		2009		2008	
Operating:						
Instruction	$ 858.6	16%	$ 820.3	16%	$ 784.7	16%
Research	671.5	13	622.6	12	571.7	12
Public service	135.8	2	126.5	2	121.9	2
Institutional and academic support	485.0	9	485.2	10	448.7	9
Auxiliary enterprises:						
Patient care	2,244.0	42	2,164.5	42	2,046.0	42
Other	145.3	3	148.6	3	179.6	4
Operations and maintenance of plant	266.0	5	277.9	5	249.2	5
Depreciation	360.1	7	341.5	7	319.4	7
Scholarships and fellowships	113.8	2	107.1	2	98.8	2
	5,280.1	99	5,094.2	99	4,820.0	99
Nonoperating:						
Interest, net	26.7	1	25.1	1	33.6	1
	$ 5,306.8	100%	$ 5,119.3	100%	$ 4,853.6	100%

Instruction and public service expenses increased 5 percent, or $48 million, to $994 million in 2010, as compared to 4 percent, or $40 million, to $947 million in 2009. These increases are consistent with the modest level of growth in the related revenue sources.

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 $1.139 billion in 2010, as compared to $1.017 billion in 2009 and $929 million in 2008. This represents an increase of 23 percent, or $210 million, from 2008 to 2010. This increase includes the impact of stimulus funds from the American Recovery and Reinvestment Act of 2009, which increased the total volume of research expenditures by 5 percent in 2010.

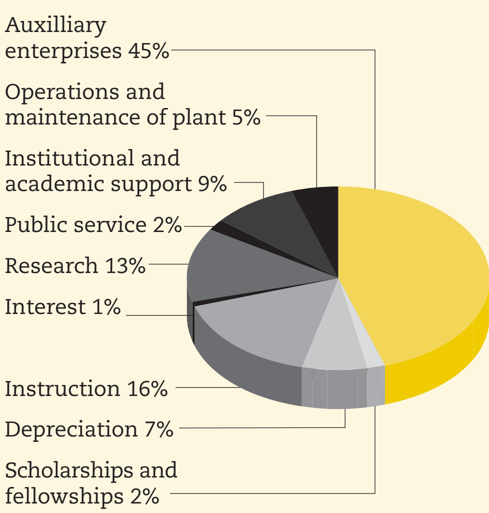
Patient care expenses increased 4 percent, or $80 million, to $2.2 billion in 2010, as compared to a 6 percent, or $119 million increase, to $2.2 billion in 2009. The increases in 2010 and 2009 are the result of increased patient activity, including costs of medical supplies and pharmaceuticals.

Total scholarships and fellowships provided to students aggregated $365 million in 2010, as compared to $327 million in 2009 and $300 million in 2008, an increase of 22 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, 2010 are summarized as follows:

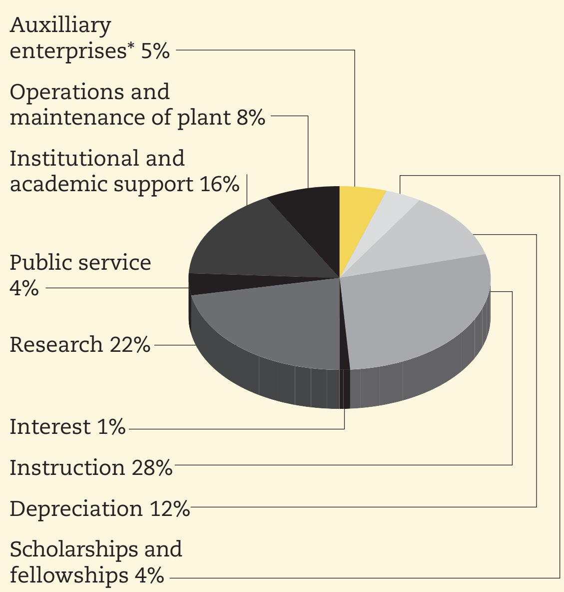
(in millions)	2010	2009	2008
Paid directly to students	$ 113.8	$ 107.1	$ 98.8
Applied to tuition and fees	233.6	202.9	184.1
Applied to University Housing	17.4	16.5	16.7
	$ 364.8	$ 326.5	$ 299.6

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

Fiscal Year 2010 Expenses by Function



Fiscal Year 2010 Expenses by Function Excluding Expenses from the University's Health System



*Excludes expenses from the University's Health System of $2.4 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, 2010 and 2009 is as follows:

(in millions)	2010	2009
Cash received from operations	$ 4,584.1	$ 4,310.3
Cash expended for operations	(4,881.0)	(4,699.3)
Net cash used in operating activities	(296.9)	(389.0)
Net cash provided by investing activities	212.0	256.1
Net cash used in capital and related financing activities	(658.7)	(575.0)
Net cash provided by noncapital financing activities	579.8	571.2
Net decrease in cash and cash equivalents	(163.8)	(136.7)
Cash and cash equivalents, beginning of year	358.4	495.1
Cash and cash equivalents, end of year	$ 194.6	$ 358.4

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, state fiscal stabilization funds, federal Pell grants and private gifts used to fund operating activities. Cash and cash equivalents decreased $164 million and $137 million in 2010 and 2009 respectively, primarily due to planned capital additions.

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 noteworthy 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 a 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. The University's budget for 2011 achieves the lowest tuition rate increase for Ann Arbor campus resident undergraduates since 1984 of 1.5 percent through aggressive cost reduction, reallocation and willingness to make tough decisions regarding priorities. To support the University's commitment to both academic excellence and accessibility, the budget for 2011 also includes 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 2012 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 totalled $792 million at June 30, 2010. Funding for these projects is anticipated to include $766 million from gifts and net assets designated for capital purposes as well as future borrowings, $24 million from the utilization of unexpended debt proceeds and $2 million from the State Building Authority. Economic pressures are expected to affect the State's future support.

The University's investment in the North Campus Research Complex 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.

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.

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.

In July 2010, the Regents approved a change in the University's endowment spending rate policy. Commencing with the quarter ending September 30, 2010, the distribution rate will begin to be lowered from 5.0 percent to 4.5 percent to more effectively protect the purchasing power of the University's endowments and the distributions they provide. The distribution rate will continue to be based upon 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.

This change is a continuation of the university's prudent financial management strategy that has allowed us to weather the recent recession while avoiding drastic measures taken by many of our prestigious peer institutions, such as faculty hiring freezes, furloughs, program cuts or halting construction. To avoid negative impacts of this change on near-term budgets, the reduced distribution rate will be implemented gradually over a number of years. Distributions will be managed towards the 4.5 percent distribution rate by keeping quarter to quarter distributions per share unchanged and only moving toward the 4.5 percent when prior increases in share value otherwise would result in higher per share distributions. The length of the implementation period will depend on the actual investment returns and resulting changes in share values experienced during the implementation period.

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.

The University continues to utilize its nationally recognized health policy experts to guide future health plan strategies. A committee on retiree health benefits was formed in 2010 to help address the acceleration of health benefits costs for current and future retirees and their dependents. This committee's work, now underway, will result in a long-term plan to keep the University's retiree benefits competitive with peer institutions while producing a minimum of $7 million in savings to the University over the next ten years, and more than $80 million by 2040. In addition, a member engagement health plan design committee, also formed in 2010, will recommend changes in our health plan design for 2012 which will include incentives for our members to engage in health and well-being activities, and have positive effects on overall wellness and the University's health care cost trend.

Additionally, U.S. health care reform will influence university benefits planning. Now that health insurance reform legislation has been signed into law, new regulatory requirements will affect health plans, providers and employers alike, and the implementation of the changes will span several years into the future. University experts are diligently reviewing and assessing the short and long-term impacts on our health plans and our health system to develop clear strategies and options for the future that will ensure compliance over the next decade of regulatory change.

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