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, 2011 and 2010 and its activities for the three fiscal years ended June 30, 2011. 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 59,000 students and 7,100 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 also has a nationally renowned health system which includes three hospitals, 40 health centers, more than 120 outpatient clinics, the University's Medical School and Michigan Health Corporation, a wholly-owned corporation created to pursue joint venture and managed care initiatives. The University, in total, employs approximately 42,000 permanent employees and 12,000 temporary staff.

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 $15.6 billion and liabilities of $4.7 billion at June 30, 2011, compared to assets of $13.8 billion and liabilities of $4.5 billion at June 30, 2010. Net assets, which represent the residual interest in the University's assets after liabilities are deducted, totaled $10.9 billion at June 30, 2011, as compared to $9.3 billion at June 30, 2010. Changes in net assets represent the University's results of operations and are summarized for the years ended June 30, 2011 and 2010 as follows:

(in millions)	2011	2010
Operating revenues and educational appropriations	$ 5,186.3	$ 4,949.3
Total operating and net interest expenses	5,463.8	5,245.6
	(277.5)	(296.3)
Net investment income	1,633.0	796.4
Gifts and other nonoperating revenues, net	205.8	198.3
Increase in net assets	$ 1,561.3	$ 698.4

Net assets increased $1.6 billion in fiscal 2011 and $698 million in fiscal 2010 primarily due to net investment income which totaled $1.6 billion and $796 million in fiscal 2011 and 2010, respectively.

Operating revenues and educational appropriations increased 5 percent, or $237 million, while total operating and net interest expenses increased 4 percent, or $218 million. The results of operations reflect the University's focus on maintaining its national standards academically, in research and in health care in a competitive recruitment environment for faculty and health care professionals. At the same time, the University is addressing declining base state appropriations and rising health care, regulatory and facility costs with aggressive cost cutting and productivity gains to help preserve access to affordable higher education for Michigan families.

Net investment income totaled $1.6 billion and $796 million in 2011 and 2010, respectively. 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 an equity oriented long-term strategy that greatly benefitted from strong equity market performance last year. The success of this long-term investment strategy is evidenced by strong returns over sustained periods of time.

Using the Financial Statements

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

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, 2011 and 2010 is summarized as follows:

(in millions)	2011	2010
Current assets	$ 2,095	$ 1,789
Noncurrent assets:		
Endowment, life income and other investments	8,122	6,807
Capital assets, net	5,193	4,956
Other	246	267
Total assets	15,656	13,819
Current liabilities	1,408	1,449
Noncurrent liabilities	3,324	3,007
Total liabilities	4,732	4,456
Net assets	$ 10,924	$ 9,363

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, 2011 and 2010, results from the prudent utilization of financial resources including careful cost controls, preservation of endowment funds, conservative utilization of debt and adherence to a long-range capital plan for the maintenance and replacement of the physical plant.

Current assets consist primarily of cash and cash equivalents, operating and capital investments and accounts receivable. Total current assets increased $306 million, to $2.1 billion at June 30, 2011, primarily due to increases in cash and investments. Cash, cash equivalents and operating investments totaled $981 million at June 30, 2011, 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 totaled $1.4 billion at June 30, 2011 and 2010.

Endowment, Life Income and Other Investments

The University's endowment, life income and other investments increased $1.3 billion, to $8.1 billion at June 30, 2011. This increase primarily resulted from unrealized gains on investments, as well as 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, 2011 and 2010 is summarized as follows:

(in millions)	2011	2010
Endowment investments	$ 7,835	$ 6,564
Life income investments	105	94
Noncurrent portion of insurance and benefits obligations investments	182	149
	$ 8,122	$ 6,807

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 7,200 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 endowment spending rule provides for distributions from the University Endowment Fund to the University entities that benefit from the endowment fund. Commencing with the quarter ending September 30, 2010, the annual distribution rate began to be reduced from 5 percent of the one-quarter lagged seven year moving average fair value of University Endowment Fund assets to 4.5 percent. This change is one element of an ongoing financial management strategy that has allowed the University to effectively weather the recent recession while avoiding drastic measures taken by many of our peer institutions, such as faculty hiring freezes, furloughs, program cuts or halting construction. To avoid negative impacts of this change on near-term budgets, endowment distributions are being managed toward the new rate by keeping quarter to quarter distributions per share unchanged and gradually moving toward the 4.5 percent rate when increases in share value would otherwise 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.

To protect endowment principal in the event of a prolonged market downturn, distributions are limited to 5.3 percent of the current fair value of fund shares. 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 totaled $266 million, $255 million and $244 million and withdrawals from funds functioning as endowment totaled $44 million, $5 million and $46 million in 2011, 2010 and 2009, respectively. Total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 5.4 percent, 5.1 percent and 5.9 percent of the current year average fair value of the University Endowment Fund for 2011, 2010 and 2009, respectively. Over the past ten years, total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 5.6 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 $635 million in 2011, as compared to $695 million in 2010. 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 $410 million, as well as debt proceeds of $224 million and state capital appropriations of $1 million.

Construction in progress, which totaled $825 million at June 30, 2011, and $546 million at June 30, 2010, includes important new facilities for patient care, research, instruction, athletics and student residential life.

At June 30, 2011, 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 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. Opening in November 2011, the new facility will enable our world-renowned physicians and researchers to deliver world-class care and train tomorrow's generation of women's and children's specialists in the finest health care environment.

Construction projects also continue 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 Alice Lloyd Hall is part of the University's residential life initiatives, a comprehensive multi-year plan to improve and expand the student residential experience. Like the deep renovations to Mosher Jordan, Stockwell and Couzens residence halls in previous years, the infrastructure of the building will be thoroughly upgraded, including high-speed network access to renovated bath facilities, accessibility improvements and new plumbing, heating, cooling, ventilation and fire detection and suppression systems. In addition, energy conservation measures will be implemented to improve the energy performance of the overall building, which was originally constructed in 1949. New spaces will be created in the vacated dining areas that are no longer needed since the Hill area Dining Center became operational in Fall 2008. The new and reorganized spaces within the facility will revitalize the residence hall and create spaces for living-learning and academic initiatives, student interaction and creation of community. This project is scheduled to be completed in Summer 2012.

Crisler Arena has only received minor renovations since its construction in 1967 and a significant renovation project is now underway to address its highest priority infrastructure needs. The seats in the lower and upper bowl of this multi-purpose venue will also be replaced, including modifications to meet the requirements of the Americans with Disabilities Act. A 57,000-square-foot Player Development Center will also be added to address the need for more functional training and practice space for the men's and women's basketball programs. The Center will connect to the east side of Crisler Arena and house two basketball practice courts, team locker areas, strength and conditioning space, athletic medicine space and coaching and staff offices. These projects are scheduled to be completed in fiscal 2012.

Renovation and expansion projects completed in 2011 include the Couzens Residence Hall and the Thompson Street Parking Structure. The comprehensive renovation of Couzens Residence Hall is part of the University's residential life initiatives to improve the residential facilities on campus and to strengthen the connections between living and learning. The Thompson Street Parking Structure addition is an integral part of the University's strategic plan to replace parking lost on central campus due to various construction projects and to provide for a growth in parking demand. This project added parking and office space to the west side of the existing structure. The expanded parking structure now accommodates 1,049 vehicles, an increase of 273 parking spaces. The office space addition provides 9,000 gross square feet of office and support space for Parking and Transportation Services and the Office of Budget and Planning, which previously utilized leased space.

In June 2009, the University completed the acquisition of the former Pfizer pharmaceutical research complex for approximately $114 million, which included 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"), the 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. The unoccupied portion of the complex is classified as property held for future use and totaled $54 million and $84 million at June 30, 2011 and 2010, respectively.

During 2011, $30 million of the acquired property was placed in service, including two significant laboratory buildings with supporting office space. Significant improvements were not needed to prepare these facilities for occupancy. More than 160 office-based researchers moved to the NCRC to start the Institute for Healthcare Policy and Innovation. Co-location of the many health service research groups currently dispersed throughout the University is beneficial given the interdisciplinary nature of the challenges in health care delivery. More than 500 researchers could eventually join this Institute, with many more engaging virtually, making it one of the nation's largest concentrations of health care policy and services researchers.

The University's Office of Technology Transfer and Business Engagement Center relocated to the complex and started a Venture Accelerator which provides a continuous innovation pipeline for faculty to move their ideas from the lab bench into a commercial reality. In addition, several laboratory-based scientific cores initiated satellite activities at the NCRC, including the DNA sequencing core. The first laboratory-based researchers, from the cardiovascular center as well as new recruits to the oncology research program, also moved to the complex.

In aggregate, 300 people moved into the complex during 2011 and thousands more utilized the facilities for conferences and events throughout the year. The NCRC will support the growth of the University's translational research initiatives through the population of office space, laboratories and other facilities over the next several years.

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 April 2011, Moody's Investors Service, Inc. ("Moody's") affirmed its highest credit rating (Aaa) for bonds backed by a broad revenue pledge based on extremely strong credit fundamentals, including significant financial resources, strong market position and consistent operating performance derived from a well diversified revenue base. In May 2011, Standard & Poor's Ratings Services ("Standard & Poor's") also affirmed its highest credit rating (AAA) based on the University's national reputation for academic and research 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, 2011, 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	$ 87	$ 85	$ 81	$ 91
Bonds and Notes:				
General revenues	1,050	220	28	1,242
Hospital revenues	300		5	295
Faculty Group Practice revenues	65		3	62
Student residences revenues	2			2
	$ 1,504	$ 305	$ 117	$ 1,692

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, 2011 and 2010, commercial paper totaled $91 million and $87 million, respectively, and is included in current liabilities.

During 2011, consistent with capital and debt financing plans, the University issued $212.3 million of fixed-rate taxable Build America Bonds (Series 2010D) and $7.2 million of fixed-rate tax-exempt general revenue bonds (Series 2010E) with a net original issue premium of $0.5 million. Bond proceeds, which totaled $220.0 million, were utilized to provide for capital projects and debt issuance costs.

The University maintains a combination of fixed and variable rate debt, which totaled $1.7 billion and $1.5 billion at June 30, 2011 and 2010, respectively. The University's fixed and variable rate debt at June 30, 2011 and 2010 is summarized as follows:

(in millions)	**2011**	**2010**
Variable rate:		
Commercial paper	$ 91	$ 87
Demand bonds	747	760
Fixed rate bonds	854	657
	$ 1,692	$ 1,504

In 2011, the University continued 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 reduce the volatility of required debt service payments and do not require liquidity support, such as letters of credit or guarantees.

Effective interest rates averaged 2.5 percent in 2011 and 2.0 percent in 2010, including the amortization of bond premiums and discounts and net of federal subsidies for interest on taxable Build America Bonds. Interest expense net of federal subsidies received for interest on taxable Build America Bonds and interest capitalized during construction totaled $26 million in 2011 and $27 million in 2010, while capitalized interest on debt financed construction in progress totaled $17.6 million and $5.6 million in 2011 and 2010, respectively.

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 variable rate bonds are put back to the University by the debt holder, management believes that the bonds 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.

Obligations for Postemployment Benefits

In accordance with the provisions of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, the University recognizes the cost of postemployment benefits during the periods when employees render their services. Using current actuarial assumptions, and presuming a continuation of the current level of benefits, the University's obligations for postemployment benefits totaled $1.64 billion and $1.61 billion at June 30, 2011 and 2010, 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 $239 million and $199 million at June 30, 2011 and 2010, respectively.

By implementing a series of health benefit initiatives over the past seven years, the University has favorably impacted its actuarial accrued liability for postemployment benefits by approximately $408 million as of June 30, 2011. These initiatives have included cost sharing changes, elimination of Medicare Part B reimbursements for certain retirees and adjustment of retirement eligibility criteria. At June 30, 2011, the recorded liability for net postemployment benefits obligations totaled $1.64 billion and the actuarial accrued liability totaled $1.18 billion. The University amortizes changes in actuarial assumptions, plan design and experience gains and losses over a 10-year closed period. Accordingly, the liability for net postemployment benefits obligations recorded in the statement of financial condition differs from the actuarial accrued liability by the unamortized portion of changes in actuarial assumptions, plan design and experience gains and losses.

In accordance with GASB Statement No. 45, the University's net obligations for postemployment benefits at June 30, 2011, do not reflect anticipated Medicare Part D prescription drug subsidies for future years of $139 million, which will offset a portion of future cash outlays.

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, 2011 and 2010 is summarized as follows:

(in millions)	2011	2010
Invested in capital assets, net of related debt	$ 3,575	$ 3,503
Restricted:		
Nonexpendable:		
Permanent endowment corpus	1,279	1,214
Expendable:		
Net appreciation of permanent endowments	1,312	924
Funds functioning as endowment	1,652	1,447
Restricted for operations and other	503	439
Unrestricted	2,603	1,836
	$ 10,924	$ 9,363

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 $72 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 $65 million increase primarily represents new gifts. Restricted expendable net assets are subject to externally imposed stipulations governing their use. This category of net assets includes net appreciation of permanent endowments, funds functioning as endowment and net assets restricted for operations, facilities and student loan programs. Restricted expendable net assets totaled $3.5 billion at June 30, 2011, as compared to $2.8 billion at June 30, 2010.

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, 2011 and 2010 totaled $2.6 billion and $1.8 billion, respectively. At June 30, 2011, unrestricted net assets included funds functioning as endowment of $3.5 billion offset by unfunded obligations for postemployment benefits of $1.6 billion. 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. Unrestricted net assets at June 30, 2011 and 2010 also included other net resources of $700 million and $500 million, respectively.

Statement of Revenues, Expenses and Changes in Net Assets

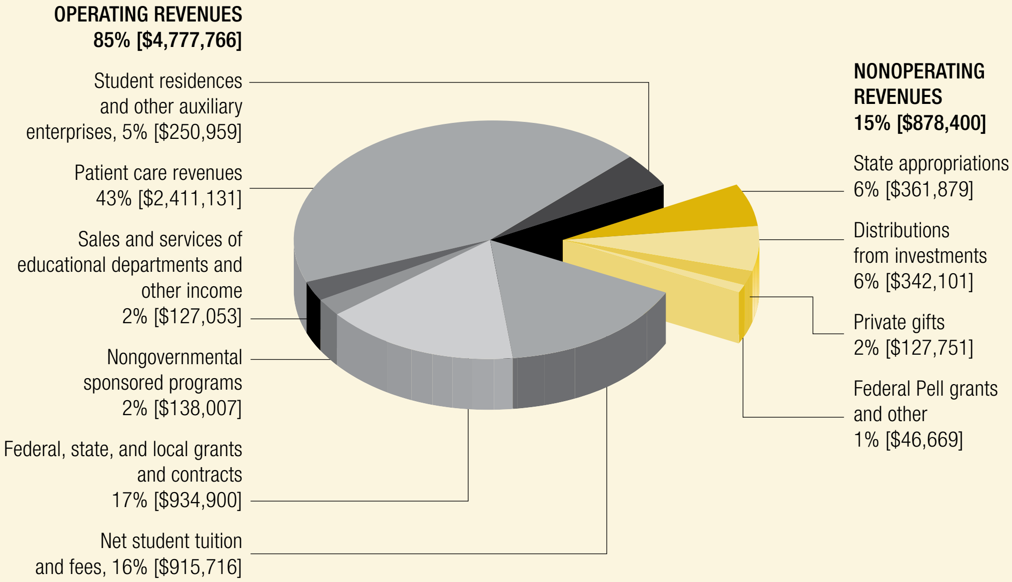
The statement of revenues, expenses and changes in net assets presents the University's results of operations. In accordance with GASB reporting principles, revenues and expenses are classified as either operating or nonoperating. A comparison of the University's revenues, expenses and changes in net assets for the three years ended June 30, 2011, is summarized as follows:

(in millions)	2011	2010	2009
Operating revenues:			
Student tuition and fees, net of scholarship allowances	$ 915.7	$ 863.9	$ 826.3
Sponsored programs	1,072.9	990.3	897.3
Patient care revenues, net	2,411.1	2,310.8	2,168.5
Other	378.1	372.2	344.4
	4,777.8	4,537.1	4,236.5
Operating expenses	5,437.8	5,218.8	5,042.1
Operating loss	(660.0)	(681.7)	(805.6)
Nonoperating and other revenues (expenses):			
State educational appropriations	361.9	362.1	373.8
State fiscal stabilization funds		10.1	
Federal Pell grants	46.7	39.9	24.9
Private gifts for operating activities	127.8	105.2	96.5
Net investment income (loss)	1,633.0	796.4	(1,851.9)
Interest expense, net	(33.1)	(30.0)	(25.1)
Federal subsidies for interest on Build America Bonds	7.1	3.3	
State capital appropriations	0.8	2.0	12.2
Endowment and capital gifts and grants	82.3	88.7	88.4
Other	(5.2)	2.4	(1.6)
Nonoperating and other revenues (expenses), net	2,221.3	1,380.1	(1,282.8)
Increase (decrease) in net assets	1,561.3	698.4	(2,088.4)
Net assets, beginning of year	9,363.0	8,664.6	10,753.0
Net assets, end of year	$ 10,924.3	$ 9,363.0	$ 8,664.6

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.

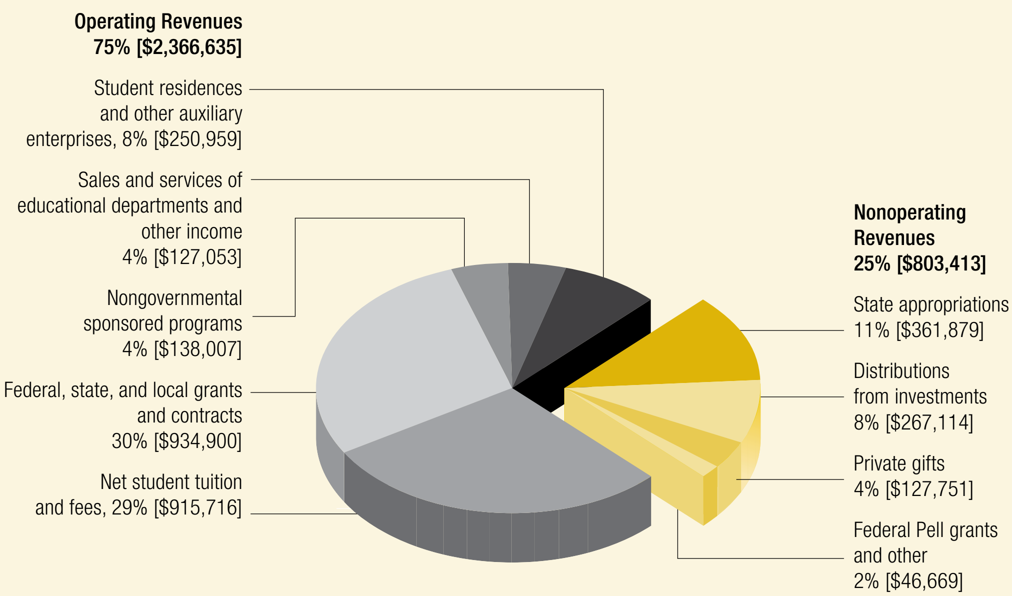
The following is a graphic illustration of revenues by source, both operating and nonoperating, which are used to fund the University's operating activities for the year ended June 30, 2011 (amounts are presented in thousands of dollars). Significant recurring sources of the University's revenues are considered nonoperating, as defined by GASB, such as state appropriations, distributions from investments, private gifts and federal Pell grants.

Fiscal Year 2011 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, 2011 (amounts are presented in thousands of dollars).

Fiscal Year 2011 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 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 4 percent, or $52 million, to $1.3 billion in 2011, as compared to 2 percent, or $26 million, to $1.2 billion in 2010.

Downturns in state of Michigan tax revenues continue to put pressure on the state budget and base state educational appropriations continue to be constrained, decreasing 3 percent, or $12 million, over the past two years, to $362 million in 2011.

To maintain academic excellence and offset constrained base state appropriations, net student tuition and fees revenue increased 11 percent, or $89 million, over the past two years. For the three years ended June 30, 2011, net student tuition and fees revenue consisted of the following components:

(in millions)	2011	2010	2009
Student tuition and fees	$ 1,177.9	$ 1,097.5	$ 1,029.2
Scholarship allowances	(262.2)	(233.6)	(202.9)
	$ 915.7	$ 863.9	$ 826.3

In 2011, net student tuition and fees revenue increased 6 percent, or $52 million, to $916 million, which reflects a 7 percent, or $80 million, increase in gross tuition and fee revenues offset by a 12 percent, or $28 million, increase in scholarship allowances. Tuition rate increases in 2011 were 1.5 percent for resident undergraduate students, 3.0 percent for nonresident undergraduate students and 2.8 percent for most graduate students on the Ann Arbor campus, with a 3.9 percent tuition rate increase for all undergraduates and 2.9 percent increase for most graduate students on the Dearborn campus, and a 3.9 percent tuition rate increase for most undergraduate students on the Flint campus. The University also experienced significant growth in the number of students.

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 $30 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 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 allocation 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 totaled $128 million in 2011, as compared to $105 million in 2010 and $97 million in 2009.

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 $83 million, to $1.1 billion in 2011, as compared to an increase of 10 percent, or $93 million, to $1.0 billion in 2010. A significant portion of the University's sponsored programs revenues relate to federal research and its growth in 2011 and 2010 is due in large part to federal stimulus funds from the American Recovery and Reinvestment Act of 2009, which totaled $128 million in 2011 and $60 million in 2010.

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 4 percent, or $100 million, to $2.4 billion in 2011, as compared to an increase of 7 percent, or $142 million, to $2.3 billion in 2010. 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 totaled $1.6 billion in 2011, as compared to net investment income of $796 million and net investment loss of $1.9 billion in 2010 and 2009, respectively. During 2011 and 2010, financial markets recovered from the impact of the global financial crisis in 2009. Equity and equity related investments across global markets performed particularly well in 2011, which helped the performance of the University's investment portfolio where all asset classes except fixed income and cash had double digit positive returns. In addition, the real estate segment of the University's investment portfolio experienced positive returns in 2011, after losses in 2010 and 2009.

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 the years preceding the crisis, 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.

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 $57 million in 2011, as compared to $60 million in 2010 and $61 million in 2009. Capital gifts and grants totaled $25 million in 2011, as compared to $29 million in 2010 and $28 million in 2009. Over the past three years, major capital gifts have been received in support of the University's wide-ranging building initiatives, which include the 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, 2011, is as follows:

(in millions)	2011		2010		2009	
Operating:						
Compensation and benefits	$ 3,633.8	66%	$ 3,529.3	66%	$ 3,390.5	66%
Supplies and services	1,299.6	24	1,215.6	24	1,203.0	24
Depreciation	390.1	7	360.1	7	341.5	7
Scholarships and fellowships	114.3	2	113.8	2	107.1	2
	5,437.8	99	5,218.8	99	5,042.1	99
Nonoperating:						
Interest, net	26.0	1	26.7	1	25.1	1
	$ 5,463.8	100%	$ 5,245.5	100%	$ 5,067.2	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 3 percent, or $105 million, to $3.6 billion in 2011, as compared to a 4 percent increase, or $139 million, to $3.5 billion in 2010. Of the 2011 increase, compensation increased 4 percent, to $2.8 billion, and employee benefits increased less than 1 percent, to $854 million. For 2010, compensation increased 5 percent, to $2.7 billion, and employee benefits increased 3 percent, to $851 million.

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 health care plan that meets their needs and share a larger portion of health care 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 76 percent generic dispensing rate in 2011, as compared to 72 percent in 2010 and 71 percent in 2009.

The University continues to utilize its nationally recognized health policy experts to guide future health plan strategies. After careful review, a series of changes are being implemented to help the University maintain competitive active and retiree benefits while helping control the growth in costs.

During 2011, the University announced changes to eligibility requirements for retiree health benefits and the related amount of the University's contributions. These changes are based on the work of a committee on retiree health benefits that was formed to propose a means to maintain competitive retiree health benefits while helping address the acceleration of health benefits costs for current and future retirees and their dependents. To assist current employees with the transition, changes will be phased in gradually over the eight-year period January 1, 2013, through January 1, 2021.

Commencing January 1, 2013, the University will use a point system to determine retirement eligibility, where points represent the combination of age and years of service for full-time employees. The points needed for retirement will total 76 in 2013 and gradually be increased to 80 by 2021. During this time period, the University's contributions towards health care benefits for employees who retire in each of these years will gradually be reduced. Employees who retire after December 31, 2020, will need a minimum of 20 years of service to receive the maximum retiree health benefit contribution. Specifically, the University's contributions towards health care benefits will decrease from 87.5 percent for the retiree and 65 percent for any dependents for those employees who retire in 2013 to a maximum of 80 percent for the retiree and 50 percent for any dependents for those employees who retire in 2021. For new hires, the maximum University contribution upon retirement with 20 or more years of service will be 68 percent for the retiree and 26 percent for any dependents, commencing in 2013. These adjustments will keep the University's retiree benefits competitive with peer institutions while producing an estimated $9 million reduction in annual cash outlay by 2020 and an estimated $165 million reduction in annual cash outlay by 2040.

Effective January 1, 2010, 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, these changes are expected to reduce the University's annual cash outlay for health care expenses by approximately $31 million.

In addition, beginning January 1, 2010, newly hired faculty and staff are subject to a one-year waiting period before receiving the University's 10 percent retirement savings plan contribution. This change results in annual savings of approximately $11 million.

The MHealthy initiative is a campus-wide effort to improve the health and well-being of faculty, staff and their dependents. During 2011, more than 20,000 employees participated in the MHealthy rewards program by completing a health risk assessment and at least one qualifying health and wellness program. Over 75 percent of all benefits-eligible employees have participated in at least one health risk assessment between 2009 and 2011. Data gathered from these assessments, as well as from aggregate medical claims, is used to monitor progress in addressing the greatest areas of community health risk.

These initiatives and programs 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 $84 million, to $1.3 billion in 2011, as compared to an increase of 1 percent, or $13 million, to $1.2 billion in 2010. The increases in 2011 and 2010 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, 2011 is as follows:

(in millions)	2011		2010		2009	
Operating:						
Instruction	$ 853.1	16%	$ 850.6	16%	$ 820.3	16%
Research	733.5	13	679.5	13	622.6	12
Public service	131.5	2	135.8	2	126.5	2
Institutional and academic support	486.3	9	485.0	9	485.2	10
Auxiliary enterprises:						
Patient care	2,285.2	42	2,182.7	42	2,112.4	42
Other	168.5	3	145.3	3	148.6	3
Operations and maintenance of plant	275.3	5	266.0	5	277.9	5
Depreciation	390.1	7	360.1	7	341.5	7
Scholarships and fellowships	114.3	2	113.8	2	107.1	2
	5,437.8	99	5,218.8	99	5,042.2	99
Nonoperating:						
Interest, net	26.0	1	26.7	1	25.1	1
	$ 5,463.8	100%	$ 5,245.6	100%	$ 5,067.2	100%

Instruction and public service expenses increased 4 percent, or $38 million, to $985 million in 2011, from $947 million in 2009. This increase is consistent with the modest level of growth in the related revenue sources offset by cost containment efforts.

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 $1.2 billion in 2011, as compared to $1.1 billion in 2010 and $1.0 billion in 2009. This represents an increase of 22 percent, or $220 million, from 2009 to 2011 and includes the impact of stimulus funds from the American Recovery and Reinvestment Act of 2009.

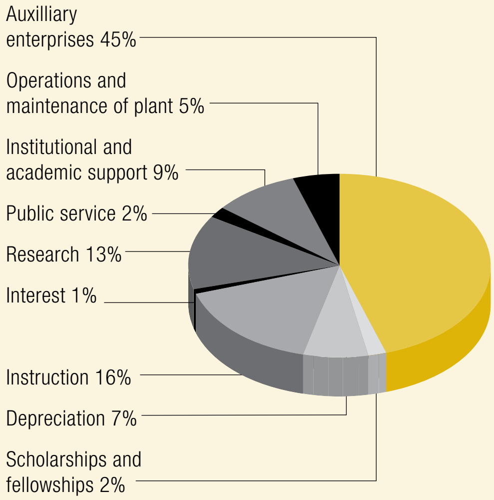
Patient-care expenses increased 8 percent, or $173 million, to $2.3 billion in 2011, from $2.1 billion in 2009. This increase is the result of increased patient activity, including costs of medical supplies and pharmaceuticals.

Total scholarships and fellowships provided to students aggregated $395 million in 2011, as compared to $365 million in 2010 and $327 million in 2009, an increase of 21 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, 2011, are summarized as follows:

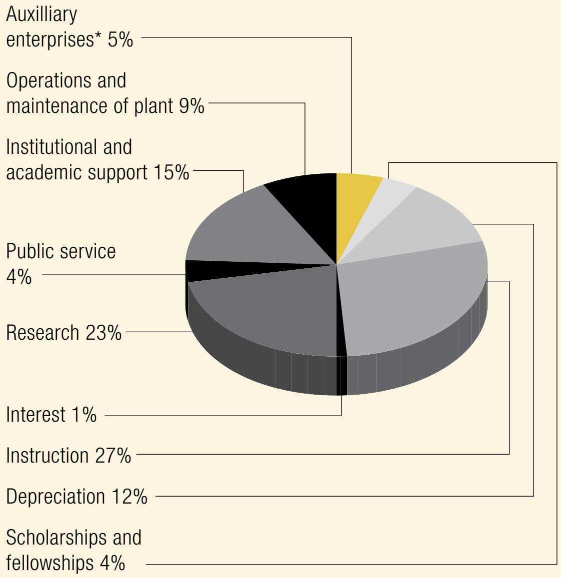
(in millions)	2011	2010	2009
Paid directly to students	$ 114.3	$ 113.8	$ 107.1
Applied to tuition and fees	262.2	233.6	202.9
Applied to University Housing	18.2	17.4	16.5
	$ 394.7	$ 364.8	$ 326.5

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

Fiscal Year 2011 Expenses by Function



Fiscal Year 2011 Expenses by Function Excluding Expenses from the University's Health System



*Excludes expenses from the University's Health System of $2.3 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, 2011 and 2010 is as follows:

(in millions)	2011	2010
Cash received from operations	$ 4,806.5	$ 4,522.9
Cash expended for operations	(5,020.5)	(4,819.8)
Net cash used in operating activities	(214.0)	(296.9)
Net cash provided by investing activities	176.5	212.0
Net cash used in capital and related financing activities	(441.7)	(658.7)
Net cash provided by noncapital financing activities	601.1	579.8
Net increase (decrease) in cash and cash equivalents	121.9	(163.8)
Cash and cash equivalents, beginning of year	194.6	358.4
Cash and cash equivalents, end of year	$ 316.5	$ 194.6

Cash received from operations primarily consists of student tuition, sponsored program grants and contracts and patient care revenues. Significant sources of cash provided by noncapital financing activities, as defined by GASB, include state appropriations, state fiscal stabilization funds, federal Pell grants and private gifts used to fund operating activities.

Economic Factors That Will Affect the Future

The University continues to 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 consistent 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 relationship between the growth, or reduction, of state support and the University's ability to control tuition increases. Over the past several years, the University has successfully addressed the realities of the state's difficult economy and, pursuant to a long-range plan, continues to work relentlessly to cut and mitigate operational costs in order to remain affordable and preserve access, while protecting the academic enterprise.

In fiscal 2012, the University faces a 15 percent, $54 million, reduction in state appropriations, the largest cut in state appropriations in the University's history. The Board of Regents has approved a budget for fiscal 2012 that fully absorbs this significant reduction in state appropriations while limiting the financial burden for students. Resident undergraduate tuition on the Ann Arbor campus will increase 6.7 percent and the University maintains a commitment to meet the full demonstrated financial need of resident undergraduate students with a 10.9 percent increase in centrally awarded financial aid for undergraduates. Resident undergraduate tuition on the Dearborn and Flint campuses will increase 6.9 percent and 6.8 percent, respectively. The University has been able to avoid the severe cuts and double-digit tuition increases experienced by institutions around the country because of its prudent long-term plan.

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, clinical and research activities. Authorized costs to complete construction and other projects totaled $623 million at June 30, 2011. Funding for these projects is anticipated to include $573 million from gifts, grants and net assets designated for capital purposes as well as future borrowings and $50 million from the utilization of unexpended debt proceeds. 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. Approximately 500 researchers and staff will move to the complex in 2012.

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.

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.

U.S. health care reform will also influence benefits planning. Since the Affordable Care Act was signed into law in March 2010, new regulatory requirements will affect health plans, providers and employers alike. The implementation of the changes has begun and will span several years into the future, with most changes taking place by 2014. 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 coming years of regulatory change. The University is also considering the benefits of a member engagement health plan design, which would include incentives for members to engage in health and well-being activities.

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