

# 2012


## Financial Report

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On the cover: The new C.S. Mott Children's Hospital lobby. Photo by Scott Soderberg, Michigan Photography.

Additional photos by Philip Dattilo; Michigan Photography; the Office of University Development; Global Reach; Michael Hodges; Peter Lang; Campbell Ewald; Architecture, Engineering & Construction; and Michigan Engineering.





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**...it was a success  
that represented  
the best qualities  
of Michigan: excel-  
lence, innovation,  
a commitment to  
sustainability, and  
work that delivers  
global impact.**



**Mary Sue Coleman**

## **Letter from the President**

Dear Friends,

To grasp the work of a great public research university, look no further than a small, sleek maize-and-blue vehicle.

It is Quantum, the latest solar-powered car designed, built, and operated entirely by University of Michigan students.

When Quantum soared across the finish line of the 2012 American Solar Challenge, not only was it first, it was a record 10 hours ahead of the next competitor.

It was U-M's fourth straight national championship. More important, it was a success that represented the best qualities of Michigan: excellence, innovation, a commitment to sustainability, and work that delivers global impact.

### **Academic Excellence**

When the academic year began with the news that three U-M faculty members were among 22 new MacArthur Fellows—tying Harvard University for the most from a single university—it was a harbinger of excellence to come. Their recognition by the MacArthur Foundation was powerful validation of individual achievements and the collective depth of the Michigan faculty.

We announced the Third Century Initiative, an investment of \$50 million to support students and faculty with approaches to tackling society's grand challenges and opportunities. Immersive learning opportunities, and support for the creativity of our faculty, will advance the greater good and secure our position as a world-class research institution as U-M approaches its third century in 2017.

We opened the new C.S. Mott Children's and Von Voigtlander Women's Hospital to great fanfare, on time, and under budget.

Our total research spending grew 3 percent, to a record \$1.27 billion. The Michigan Institute for Clinical and Health Research received one of the largest National Institutes of Health grants, with glowing comments from NIH leaders. And through a rigorous peer review process, the U-M Comprehensive Cancer Center was again chosen as one of 41 National Cancer Institute comprehensive cancer centers.

U-M's academic strength is rooted in the diversity of our students and faculty, and we are committed to attracting the best. We work tirelessly to control costs for students and their families, because we do not want to lose anyone due to financial pressures. The university again this year was able to significantly boost financial aid—to the point that most in-state students with financial need saw no increase in the cost of attendance.

### Entrepreneurship and Innovation

It was a pleasure to announce MINTS—Michigan Investment in New Technology Startups—and show our support for innovative faculty. MINTS combines the fiscal savvy of a good investment and the enduring confidence in our scholars by investing up to \$25 million over the next 10 years in faculty startup companies. During the past decade, 92 U-M startups have been created.

We also launched MCubed, a \$15 million research funding initiative that supports faculty from different disciplines coming together to create projects. MCubed puts professors in charge of divvying up research dollars in a pure form of peer review. A two-year pilot itself, it aims to fund pilot studies that could eventually lead to larger traditional grants.

With the support of the National Highway Traffic Safety Administration, we launched a \$25 million "smart car" study. Nearly 3,000 vehicles are being outfitted with wireless communication devices that will let cars, trucks, and buses "talk" to each other, as well as to traffic signals located throughout a test-pilot area in Ann Arbor. The goal: save lives and reduce injuries among motorists.

The North Campus Research Complex continues to expand with talent and programs. New occupants this year include the Translational Oncology program, the Institute for Healthcare Policy and Innovation, and the BioInterfaces think tank.

### Global Engagement

We take our global presence seriously. When the 2011 QS World University Rankings were announced, U-M was the top public university, and 14th overall. We are committed to providing our students and faculty with unique opportunities that expose them to the challenges of today's global environment.

Our comprehensive efforts were recognized by the Association of International Educators, which awarded U-M its Senator Paul Simon Award for leadership, innovation, and outstanding accomplishment.

The university is connecting people around the globe with the world's leading professors through Coursera, an online learning experience. When Coursera was unveiled, Michigan was one of four world-class universities—and the sole public institution—to offer classes. Our faculty members are eager to share their knowledge globally, and our students are equally excited about experimenting with this new approach to learning.

### Sustainability

We announced an unprecedented new graduate education program that will accelerate how we teach and research sustainability. With a landmark \$10 million gift from The Dow Chemical Company, the university will train 300 leaders in global sustainability over the next six years.

We see this cadre of students as the next generation of sustainability leaders, dedicated and well-trained experts who know how to work not only within but among disciplines—such as natural science, policy, law, engineering, social science, and more—to become a new vanguard.

Lastly, this past year was personally significant, as it marked a decade of leading this great university. I am deeply appreciative of the support and counsel of the Board of Regents, and have never been as energized as I am approaching the new academic year of 2012–13.

At Michigan, our goal is to make a difference. This has been a remarkable year, and I look forward to an even more spectacular future, with U-M making a positive impact in the world.



Mary Sue Coleman  
President



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**The university's facilities serve a wide range of needs, from research efforts and patient care to academics and the arts.**



Timothy P. Slottow



## Report from the Chief Financial Officer

I'm very pleased to report that the University of Michigan continues to be financially healthy. This is largely due to U-M's 42,000 faculty and staff who are keenly focused on the institution's core missions while, at the same time, endeavoring to develop new ideas to contain costs, maximize resources, and increase efficiencies. Because of this unyielding commitment to building on the institution's strong foundation and tradition of excellence, we continue to have the resources to make strategic investments in the facilities, programs, and people that make U-M one of the best public research universities in the world.

The university continues to maintain the highest credit ratings from both Standard & Poor's (AAA) and Moody's Investor Services (Aaa). These ratings are important indicators of the institution's strong financial health and outlook. U-M is one of only three public universities in the country to maintain these ratings—the highest possible—from both of these agencies.

Our disciplined budget approach carefully balances the university's requirement to be competitive against the challenging economic environment that we've faced for a number of years. To that end, our long-term strategy has focused on ensuring tuition increases are moderate as well as developing and implementing innovative cost containment strategies, and successful fundraising efforts, all while relentlessly protecting and enhancing the world-class quality of the institution's research, teaching, and clinical care. When combined with our long-term investment strategy, this approach ensures a strong future for the university.

The university's total net assets (assets less liabilities) decreased \$171 million to \$10.8 billion at June 30, 2012, following an increase of \$1.6 billion in 2011. Key changes from 2011 to 2012 include a \$1.56 billion decrease in net investment income, a \$206 million increase in net operating loss before endowment and working capital distributions (calculated as operating and net interest expense in excess of operating revenues and educational appropriations) and a \$38 million increase in capital gifts and other nonoperating revenues. The increased operating loss before investment distributions for operations includes an anticipated reduction in hospital operating margin of \$64 million; a planned spend down of medical school auxiliary fund balances of \$35 million to bridge current year reductions in federal research funding revenues and reduced general fund appropriations; and a planned spend down of university reserves to support enterprise-wide information technology projects and other initiatives.

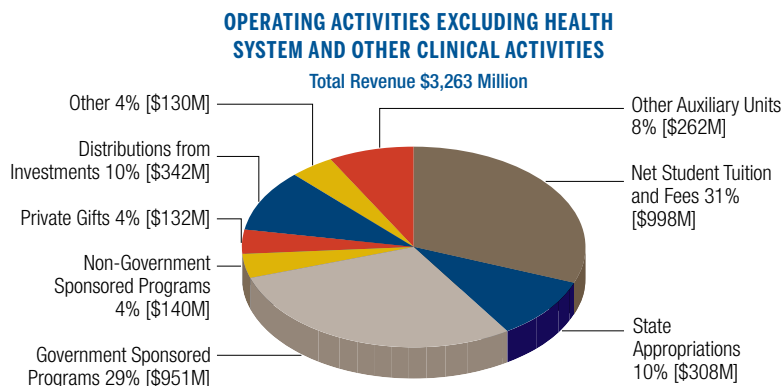
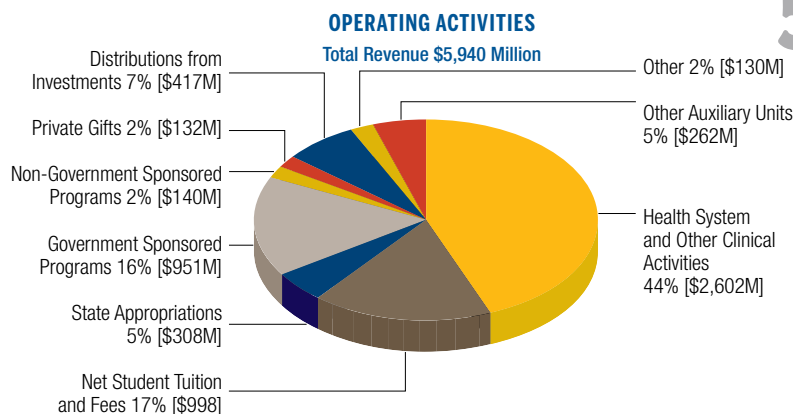
We expect net investment income to be volatile from year to year, based on our experience over the last decade, and utilize an endowment spending rule policy together with our long-term investment strategy

to insulate the university from this volatility and provide dependable annual support for operations. Combining endowment distributions and working capital investment income with operating results, the university continues to experience a positive overall operating margin.

In the following sections, I will discuss these contributors and provide updates on several university-wide efforts affecting the university's overall financial health to provide context to the accompanying financial statements.

### REVENUE DIVERSIFICATION

Revenue diversification has long been an important strategy for the university to achieve financial stability in light of unpredictable economic cycles. In the 1960s, for example, nearly 80 percent of the university's general fund revenues came from state appropriations, compared to the projected 17 percent in the FY 2013 general fund budget. The current mix of revenue can be seen on the charts below, which show the FY 2012 operating revenue sources with and without the health system and other clinical activities.



## THE GENERAL FUND OPERATING BUDGET CHALLENGE

State appropriations have declined significantly since FY 2002, with state support per student declining by more than 50 percent after adjusting for inflation, from \$13,262 per student in FY 2002 to \$6,444 per student in FY 2012. Total state appropriations decreased from \$416 million in FY 2002 to \$308 million in FY 2012, a decrease of \$108 million, or 26 percent. This includes the largest cut in school history—a 15 percent, or \$54 million, reduction in FY 2012. In contrast, if appropriations had grown at the level of the Consumer Price Index for Detroit, our state appropriations would have been nearly \$200 million higher in FY 2012. However, support from the state of Michigan remains a key element in the university's strength. To put the importance of the state's current support in perspective, it would take an additional endowment of approximately \$7 billion to generate an equivalent revenue stream.

In FY 2013, the university will receive a modest increase of 2.7 percent to our appropriation from the state of Michigan. We are grateful for this increase and the adopted budget remains focused on limiting the financial burden for students. In addition, the budget demonstrates an unwavering commitment to the quality of the university, both inside and outside the classroom. The general fund operating budget continues to balance our ongoing focus on academic excellence and access with our long-term cost containment efforts and the need to invest in our future. Multi-year budget planning, prudent management of resources, and our willingness to make tough decisions regarding priorities have enabled us to prepare for—and smooth out—the impact of the tumultuous financial situation that has faced both the state and nation in recent years. This long-term plan and focus has enabled us to avoid the severe program cuts and double-digit tuition increases experienced by other institutions around the country.

A disciplined approach to long-term cost containment is a driving force behind our ability to limit tuition increases, provide more financial aid, and continue to invest in teaching and research. The university's deans, directors, faculty, and staff reduced and reallocated \$235 million in recurring general fund expenditures from the Ann Arbor campus budget over the period FY 2003–2012. Beyond that, we're planning to reduce or reallocate recurring costs by another \$120 million by 2017. Our cost containment efforts currently underway include information technology rationalization, strategic sourcing, and administrative services transformation.

The approved Ann Arbor campus budget for FY 2013 includes tuition rate increases of 2.8 percent for resident undergraduates, 3.5 percent for nonresident undergraduate students, and 3 percent for most graduate programs. The Ann Arbor campus budget also includes \$145 million in centrally awarded financial aid, the largest investment in financial aid in the university's history. Within that, centrally awarded financial aid for undergraduates is increasing by 10 percent, which will help in our

ongoing efforts to preserve access for our most financially vulnerable undergraduate students.

For the fourth year in a row, there will be no increase in the cost to attend U-M for the typical Ann Arbor campus undergraduate resident student who has financial need. The FY 2013 financial aid investment is sufficient to cover the full increase in the cost of attendance (tuition and fees, housing, textbooks and incidentals) with grant aid for these students, resulting in no increase in packaged loan burden. In addition, the loan burden in the 2013 financial aid package for these students is less than in 2009.

The UM-Dearborn budget includes a 3.7 percent increase in undergraduate and graduate tuition rates, the lowest increase since the 2004–05 school year, and a 15 percent increase in institutional financial aid. UM-Flint's approved budget includes a 3.6 percent increase in undergraduate tuition rates, a 2.8 percent increase in graduate program tuition, and a 5.8 percent increase in institutional financial aid.

## THE HEALTH SYSTEM

The U-M Health System—which integrates the Hospitals and Health Centers, Medical School, Michigan Health Corporation, and shared administrative services under the direction of the university's executive vice president for medical affairs—continues to receive national recognition for its academic and clinical excellence.

In FY 2012, the U-M Hospitals and Health Centers (UMHHC) began the year predicting an operating loss of 1.1 percent due largely to the activation and one-time costs associated with opening the new state-of-the-art, 1.1 million square foot facility for the C.S. Mott Children's Hospital and Von Voigtlander Women's Hospital, expansion of the adult emergency department, and implementation of the first phase of MiChart, U-M's electronic medical record system. By year's end, the operating loss had been reduced to a 0.5 percent loss on revenues of \$2.1 billion, due to a number of factors including more patients and improved efficiency. Despite the disruption caused by its significant capital projects, UMHHC experienced nearly 5 percent more patient activity, in terms of adjusted cases, when compared to the previous year. If the operating cost impact of those three large projects is not included, UMHHC ended the year with a positive operating margin of just under 3 percent.

UMHHC continues to invest in capital projects to accommodate patient demand, and provide better service through a range of new facility and technological investments. During FY 2013, a construction project will commence to renovate the former children's and women's hospital facility into a Neuroscience Hospital and realign space in University Hospital. In addition, construction will begin on a new multi-specialty health center in Northville Township to increase outpatient capacity in the I-275 corridor.



The combined impact of Michigan's prolonged economic downturn, health care reform, performance-based reimbursement by insurers, and a highly competitive federal research funding environment continues to put pressure on operations. Charity care, uncompensated care, and reduced reimbursement from local, state, and federal coverage plans, and programs to support the training of resident physicians, must all be balanced with income from privately insured patients. Hence, the importance of bolstering capacity and statewide/nationwide reach while also streamlining operations.

In FY 2012, a new Pioneer Accountable Care Organization, launched in January together with regional physician group IHA, and a new master affiliation agreement with the Michigan hospitals of Trinity Health, set the stage for better population health management and appropriate use of U-M's advanced care options. In addition, the Health System continued its investment in team problem-solving and continuous process improvement, using "Lean" tools and techniques. This effort emphasizes process redesign which adds value while reducing process time and costs to provide necessary care and related services.

U-M is also playing a leading role in the statewide quality improvement consortia funded by Blue Cross Blue Shield of Michigan, and in the Washtenaw Health Initiative that anticipates the full implementation of coverage for more uninsured residents under the Affordable Care Act. These efforts, and more, will be important in FY 2013 and beyond.

## GROWING RESEARCH

Total research spending in FY 2012 totaled \$1.3 billion, the fourth straight year the university has surpassed the billion-dollar milestone. Over the last decade, total research expenditures have more than doubled even as the rate of increase of federal funding has eased off, showing the strength of U-M's competitive standing among its peer research universities. It is likely that federal support for research will continue to be constrained in coming years, and that competition for available funds will rise. Efforts are underway to diversify and strengthen U-M's research portfolio by expanding support from industry as well as from federal agencies where research funding has been growing, including the Department of Transportation, the Department of Energy, NASA, the Department of Defense, and the National Science Foundation.

Transferring the fruits of U-M research to the marketplace remains a high priority. Over the last decade, U-M developed technologies have contributed to an average of ten new startup companies per year. To enhance the success rate of these firms with licensed technologies that originated in faculty labs, U-M launched the Michigan Investment in New Startups (MINTS) initiative. Once a faculty startup has secured an initial round of funding from a qualifying independent venture capital firm, it will also be eligible for available funding through the university's MINTS

program. The university can reap the benefits of its initial investment when a company either is acquired or goes public.

Further progress was also made in realizing the potential of the North Campus Research Complex (NCRC), the property acquired from Pfizer in 2009. At the close of FY 2012, more than 1,400 faculty, staff, students, and private company employees were working at the NCRC in translational science initiatives and related research support facilities. In addition, the NCRC leases space to the VA Ann Arbor Healthcare System, two established private companies, and 18 faculty startup companies participating in U-M's Venture Accelerator. Moving new startup ventures more quickly and effectively to the marketplace is the main goal of the Venture Accelerator, which resembles a business incubator but is distinguished by the diverse array of services it offers to tenants—a suite of resources typically not available at business incubators. The university is committed to catalyzing the transformation of the economy by supporting technology transfer, encouraging entrepreneurship and linking faculty and businesses to spur innovative research.

## IMPROVING TECHNOLOGY

Information technology (IT) is the backbone of a global research university. As part of the university's NextGen Michigan initiative, Michigan IT is undergoing transformative change that includes creating shared services for the hardware, storage, networking, support, and other services that are needed to run the university, while building new, modern services that advance the missions of research, teaching and learning, and patient care. In FY 2012, U-M focused on multi-year cost reduction initiatives to be achieved through rationalizing the current infrastructure, enhancing the research IT environment and increasing compliance.

NextGen Michigan is a university-wide initiative to invest in new technologies that support U-M's future needs and to become more efficient at providing current technology services. In FY 2012, the university rolled-out Google's suite of online collaboration tools, e-mail, and calendaring systems to faculty, staff, and students; developed partnerships with peer universities to offer new cloud-based storage solutions; designed new services to consolidate and enhance desktop support, campus networking services, and cloud computing capabilities; and enhanced high-performance computing assets to support research activities. Also this year, U-M constructed its first modular data center, which uses ambient air for cooling approximately 75 percent of the year, thus significantly reducing the amount of power needed for cooling and contributing to sustainability efforts.

The university also continues to improve and enhance its enterprise-wide systems. The Donor & Alumni Relationship Tool, which became operational in FY 2012, replaced the university's last mainframe application. This new system improves the donor's experience throughout the gift process as well as the efficiency and effectiveness of the university's gift stewardship and

development business processes. In FY 2012, the university also implemented an automated solution that streamlines termination of employment transactions by replacing paper-based processes with online transactions and workflow approvals, which eliminates paper and manual data entry in central HR offices when employees decide to leave the university. In addition, the university made critical enhancements to its Travel Registry, which collects and makes available critical traveler information in the event of an emergency, including a simplified registration process and automatic notifications when travelers register for countries with warnings or restrictions.

## PHYSICAL PLANT IMPROVEMENTS

The university's facilities serve a wide range of needs, from research efforts and patient care to academics, athletics and the arts. Over the last 10 years, the university has invested an average of \$523 million per year for renovation and replacement of buildings and related infrastructure. In FY 2012, the university completed nearly 300 projects across campus. A number of significant facilities to support the university's ever-changing academic, research, patient care, and athletic functions have recently been completed or are presently under construction. Refer to pages 34-37 for a summary of major capital projects in planning, in progress, and completed during FY 2012.

Renovation of residence halls continued pursuant to the university's Residential Life Initiatives, a multi-year plan to revitalize and expand the residential experience for U-M students and to strengthen the connection between living and learning on campus. Alice Lloyd Hall, which is home to more than 500 students and the latest Hill area residence hall to be renovated, reopened in August 2012. Like the extensive renovations to Mosher Jordan, Stockwell, and Couzens residence halls in previous years, the infrastructure of the building was thoroughly upgraded, including high-speed network access, accessibility improvements, renovated bath facilities, and new plumbing, heating, cooling, ventilation and fire detection and suppression systems. In addition, energy conservation measures were implemented to improve the energy performance of the overall building, which was originally constructed in 1949. The renovations also created much needed spaces for living-learning and academically-related activities, dance practice and multipurpose space, art studio, music practice rooms and spaces for student interaction and community development. Renovations are currently underway at East Quadrangle, a 300,000 square-foot residence hall that is home to nearly 900 students and the university's Residential College.

## THE ENDOWMENT

The university's long-term diversified investment strategy is designed to maximize total return, while our spending rule policy is designed to protect and grow the endowment corpus in real terms and provide dependable support for operations.

## INVESTMENT PERFORMANCE

	Return for the twelve-month period ended June 30, 2012	Annualized five-year return	Annualized ten-year return
LONG TERM PORTFOLIO	-0.5%	2.5%	9.6%
U-M'S BENCHMARK	1.3%	2.0%	7.5%
BLENDED PASSIVE INDEX	-1.7%	0.0%	4.9%

The Long Term Portfolio's -0.5 percent return in FY 2012 follows a 24 percent return in FY 2011 and a 12 percent return in FY 2010. The Long Term Portfolio's annualized ten-year return of 9.6 percent was 2.1 percentage points above the custom market benchmark designed to capture the university's long-term diversified investment strategy and 4.7 percentage points over the university's blended passive index, which captures the performance of passive, investable asset class benchmarks representative of a large institutional investment pool and is linked to the performance of major equity and fixed income indices in an 80/20 ratio for periods longer than one year. The return of the S&P 500 stock index was 5.3 percent over the same ten-year period.

The table above shows the Long Term Portfolio's favorable investment performance relative to its benchmarks. Utilizing a diversified investment strategy has limited the loss of capital in the more challenging years.

The university's endowment spending rule smooths the impact of volatile capital markets by providing for annual distributions based on a percent of the moving average fair value of endowment shares. The spending rule, along with the growth of the endowment, allowed for distributions to support operations of \$270 million in FY 2012, for a total of \$1.3 billion over the past five years.

The payout from approximately 7,600 separate endowment funds enables us to serve a diverse population, ranging from patients in our health system to students. For example, approximately \$1.8 billion, or 23 percent, of our \$7.7 billion endowment is restricted for use by our health system, where more than 2 million patient visits take place each year.

The portion of the endowment available for U-M operations supports the education of approximately 60,000 students. About 20 percent of our total endowment, or \$1.5 billion, has been set aside for student aid, with 70 percent of our undergraduate students who are Michigan residents receiving some form of financial aid, which includes grants, work-study, and loans. Endowment income also provides key support to the university's research efforts, which have made countless contributions to our global society in areas ranging from medicine and law to the arts and sciences. The average effective annual spending rate from our endowment over the last ten years, including spending rule payouts and withdrawals from funds functioning as endowment, primarily for strategic capital investment, was 5.4 percent.



## CONTROLLING BENEFIT COSTS AND IMPROVING HEALTH

The university remains very attentive to the cost of employee and retiree health benefits. This is an ever-present challenge for organizations across the country. Drawing on the combined expertise of top clinical and health policy faculty and financial experts, the university has been adjusting its health benefits premium structure and eligibility requirements pursuant to a multi-year plan. In doing so, the university closely monitors key benchmarks to ensure that it remains competitive with local and national labor markets after making the adjustments.

For the university, total health care spending for more than 92,000 employees, retirees and dependents was approximately \$325 million in FY 2012. The changes to the health care premium structure that began implementation in FY 2004 are now generating cash savings of more than \$30 million annually. This fiscal year also marked the second year of a two-year adjustment to health benefit cost sharing, which provides an additional reduction in cash outlays for university healthcare expenses of \$31 million annually.

Changes to retirement eligibility rules and the amounts of university contributions toward health care for future retirees will begin to take effect on January 1, 2013. These changes are projected to yield recurring annual cash outlay savings of more than \$9 million by the year 2020 and \$165 million by 2040, helping to preserve vital funding for the university's core missions and creating greater opportunity to control the rate of future tuition increases.

MHealthy, the university's health and well-being program, works in conjunction with benefits programs and initiatives to curb the rate of increase by prevention, early intervention, and wellness. Programs help individuals with low health risks to stay healthy and engage those with greater risk or chronic conditions to improve their health. Nearly 29,000 of the university's 42,000 employees participated in at least one MHealthy program over the last three years. Recently published results over the same three-year period showed a reduction of 2.1 percent in the university's benefits-eligible population with high health risks, and a 4.1 percent increase in the number of people who are now at low risk.

The university also regularly scrutinizes vendor contracts to ensure they remain highly competitive in changing marketplaces. A new third party Pharmacy Benefit Manager was selected to administer the university's Prescription Drug Program, a change that takes effect in October 2012 and will save approximately \$13 million over 39 months. Likewise, competitive vendor selection resulted in a change in the mail order pharmacy serving the university's plan members for estimated annual savings of \$840,000, commencing in calendar year 2012, and fee reductions negotiated for health plan administrative services will reduce annual costs by another \$2.7 million.

## INTERNAL CONTROLS

The university continued its nearly decade-long focus on creating and maintaining a robust internal controls program. More than 40 deans, directors and vice presidents from both academic and administrative units across campus complete an annual internal control review and certification of internal controls and financial information.

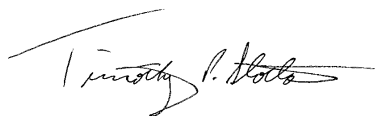
For FY 2012, we added promotion and communication of the University Compliance Hotline to the annual certification process to increase the awareness of the hotline throughout units on campus. The hotline can be used to anonymously report financial, regulatory, NCAA, or patient safety concerns. We also added control guidance for financial aid to the unit certification process which includes risk areas such as financial stewardship, information technology security, conflict of interest, and identity theft prevention. Internal control guidance is provided to units through the use of a variety of on-line tools for areas such as employment, P-Cards, employee travel and expense, cash handling, journal entries, human subject incentives, and use of gift cards.

In addition, the university advanced its Enterprise Risk Management initiative on several fronts. The Office of General Counsel continued to use its comprehensive Compliance Resource Center website to outline and promote the many roles and responsibilities within U-M for every major compliance risk area. A series of formal workshops were held with Executive Officers that resulted in a prioritized set of key operational and strategic risks and impacts to the university's academic mission.

## CONCLUSION

It is, once again, satisfying to receive an unqualified opinion from the university's independent financial auditors. This opinion, which appears on page 39, signifies that the financial statements present fairly the financial position of the university. On page 38 is my certification of management's responsibility for the preparation, integrity, and fair presentation of the university's financial statements.

I hope you will read Management's Discussion and Analysis, which begins on page 40. It includes details on how the university's financial strength, prudent financial policy, and the institution-wide commitment to maintaining the highest level of excellence work together to ensure the university's mission is met in the future.



Timothy P. Slottow  
Executive Vice President  
and Chief Financial Officer

A photograph of several students in a computer lab or classroom. They are seated at long wooden tables, working on laptops. The room is dimly lit, with warm light from large yellow lampshades on the tables. Large windows in the background show a view of trees. A potted plant is visible near the windows. The students are focused on their work, with some wearing headphones.

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**“Donors made  
gifts to the  
endowment  
for financial  
aid totaling  
\$28 million.”**

- Jerry A. May





Jerry A. May

## Report from the Vice President for Development

Fiscal Year 2012 demonstrated once again that the University of Michigan has exceptionally generous alumni and friends whose dedication and generosity ensure that it will continue to fulfill its mission as a world-class research university. This fiscal year, approximately 120,000 donors, 4,000 more than last year, made gifts and pledge payments totaling \$288 million, a 5.5 percent increase over last year's total. Gifts from living individuals increased to \$197 million, up \$35 million more than last year's total of \$162 million. Gifts from corporations totaled \$17 million, down about \$2 million from last year's total of \$19 million, while gifts from foundations totaled \$47 million, up slightly over last year's total of \$46 million.

The impact of donor generosity is evident throughout the university.

In the Law Quadrangle, a massive renovation project is underway, thanks to **Charles Munger (HLLD LAW '10)**, a donor who generously supports infrastructure priorities. His gift of \$20 million is improving the Lawyers Club, where generations of law students have lived. Previously, he funded a major renovation of the original Law Library, bringing that stunning facility back to its original splendor through improved lighting and vastly improved infrastructure.

In December, the spectacular, new C.S. Mott Children's Hospital and Von Voigtlander Women's Hospital opened, a testament to thousands of donors. The **Charles Stewart Mott Foundation** made a landmark gift of \$25 million, and **Gwen (Von Voigtlander) Haggerty** made a gift of \$15 million—the largest gift dedicated to women's health—to honor her parents, Ted and Jane Von Voigtlander. Along with those two exceptional gifts were thousands of other gifts of all sizes, including those

### Among the areas that donors designated for their support:

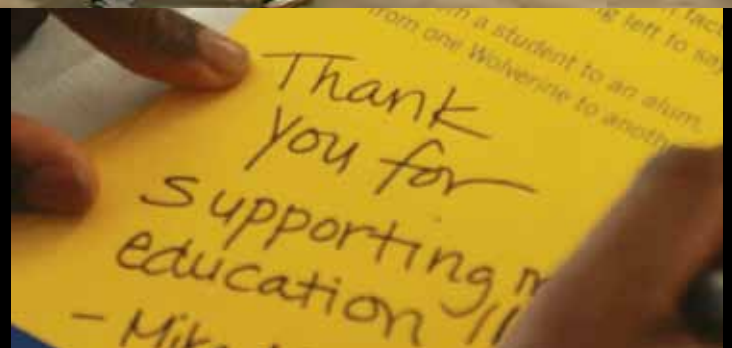
FACILITIES	\$64 million
FACULTY	\$16 million
PROGRAMS	\$57 million
RESEARCH	\$71 million
STUDENTS	\$43 million

from schoolchildren, and participants of car washes, golf outings, dinners, and other fundraising events. The result is an amazing facility that provides exceptional service and care to women and children.

Providing students with assistance so they can afford a U-M education is one of our highest priorities. Donors made gifts to the endowment for financial aid totaling \$28 million, increasing the total amount in the endowment designated for student support to \$817 million. These endowed funds generated \$67 million for students. In addition, donors made expendable gifts for student aid totaling \$15 million for a total of \$82 million, which benefited about 12,000 students.

In addition to the gifts and pledge payments reported above, the University of Michigan has received pledges for gifts that will have a tremendous impact on our ability to educate students and to conduct exceptional research. The **Dow Chemical Company** made a \$10 million commitment to create the Dow Global Sustainability Fellows, an unprecedented collaboration with U-M that will bring together nearly 300 students from all areas of study to find interdisciplinary, actionable, and meaningful sustainability solutions to pressing problems. The program includes fellowships for masters, doctoral, and postdoctoral students and a supporting lecture series focused on sharing sustainability research and best practices. This exciting new partnership will drive innovation. The first Dow Sustainability Fellows will be selected in Fall 2013. Dow has been a long-time generous supporter of U-M, and this latest gift dramatically advances the university's commitment to sustainability.







The College of Engineering received the largest gift in its history dedicated to fellowships. **J. Robert Beyster (BSEM '45, BSEP '45, MS '47, PhD '50)** made a gift of \$15 million to create the Beyster Fellows Program that supports students in fields that link high-performance computing to applications with real-world impact. The program will support up to 10 engineering doctoral students each year and provide funding for renovations of the Ford Nuclear Reactor building and for the Center for Entrepreneurship. In recognition of the gift, the Computer Science and Engineering Building has been named the Bob and Betty Beyster Building.

The late **William Davidson (BBA '47, HLLD '01)** was a member of the U-M track and field team, a lifelong sports enthusiast, and owner of three teams: the Detroit Pistons, the Detroit Shock, and the Tampa Bay Lightning. He had demonstrated his love for and dedication to U-M by establishing, through Guardian Industries, the William Davidson Institute in the Stephen M. Ross School of Business. This year the William Davidson Foundation provided a leadership gift of \$7.5 million in support of Athletics. In recognition of this gift and his ongoing support to the university, the new basketball practice facility that opened in January was named the William Davidson Player Development Center.

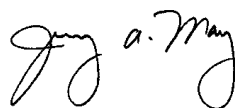
The President's Challenge for Student Global Experience offered \$1 for every \$2 from donors to create endowed funds for global experiences for our students for a total in matching gifts of \$5 million. The challenge ended this fiscal year and was a rousing success with \$10 million pledged by donors for a total of \$15 million now dedicated for global experiences. **Keenan and Orna Wolens** took advantage of the challenge and created a \$100,000 fund for study abroad in the Jean and Samuel Frankel Center for Judaic Studies in the College of Literature, Science, and the Arts (LSA). They made their gift through the Parent and Families Giving Program since their son, Ethan, is a sophomore. Two brothers who are fathers of LSA students, **Howard Kurtzman**, father of Drew Anne, a junior, and **Rick Kurtzman**, father of Ethan, a junior, made a gift of \$100,000 to support global study for Screen Arts & Cultures students, in LSA. The Wolens and the Kurtzmans serve on the Parent and Family Leadership Council.

On an unseasonably warm day in March, U-M students celebrated their first Day of Thanks, an event to recognize donors and thank them for their financial support. Throughout campus, students learned about the impact of donor gifts and wrote notes of thanks. This first Day of Thanks not only educated students on the role private giving plays in their U-M experience, but also celebrated philanthropy at U-M. We are pleased to help our students understand the vital role of philanthropy at the university and to encourage them to become the next generation of donors.

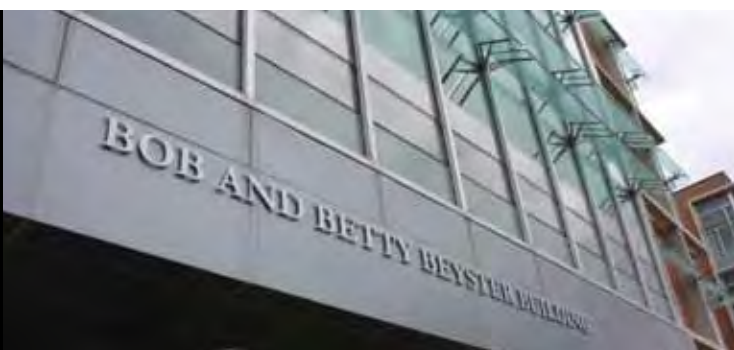
The University of Michigan lost a dear friend, alumnus, supporter, and volunteer this year. Legendary newsman **Mike Wallace (AB '39, HLLD '87)** passed away in April. Then, in September, Mike's wife of 26 years, Mary, passed away. While Mike gave his enthusiasm and advocacy to the entire university, he was truly the guiding light of the Knight-Wallace Fellows Program. He and his wife Mary provided the Mike and Mary Wallace House, the home for the journalism fellows who come to U-M mid-career for a year to study, learn, explore, and expand their abilities. He endowed an investigative reporting fellowship, and provided support for the entire program. Mike's financial generosity was matched by his contributions of time, expertise, and energy. He also lent his support to the university's Depression Center. He came to the U-M as a freshman on a train from New York, aptly named the Wolverine, and remained a loyal member of the University of Michigan family throughout his life. We will miss him and Mary.

These examples are just a few of the many from the past fiscal year. Every one of the 120,000 donors this year has a unique story about their gift and each gift has made an impact on the life of the university.

The University of Michigan could not achieve all that it does without its donors and volunteers whose generosity continues to astound and impress us all. We are grateful for your support, your loyalty, and your commitment. Thank you.



Jerry A. May  
Vice President for Development







# The Year in Review

## What happened at U-M last year?

Brand-new hospitals, \$1.27 billion in research spending, a record number of freshman applications, a robot that runs like a human. . . and a whole lot more.

We couldn't possibly include everything of note that transpired in 2011–12. So we've highlighted our "Big 10" categories to bring you the most transformative, innovative, and engaging news and events of the past year.

So read, browse, and enjoy. Please visit our website at [finance.umich.edu/reports/2012](http://finance.umich.edu/reports/2012) to download an electronic version.

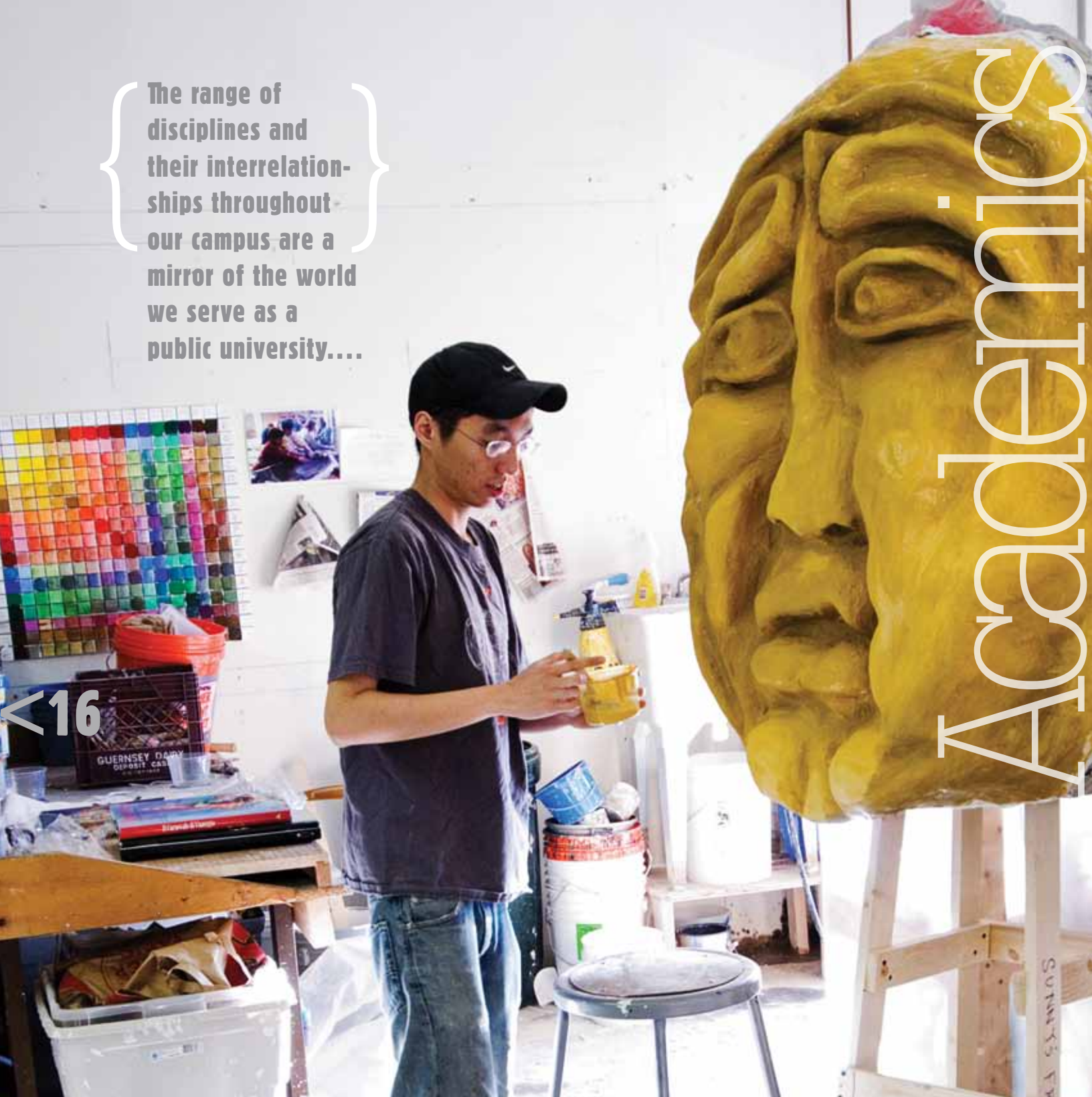
- 1 **Academics** lists new U-M rankings
- 2 **Student Profile** highlights U-M's student body
- 3 **Global** outlines international engagement
- 4 **Health System** introduces the new hospitals and more
- 5 **Research** looks at spending and discovery
- 6 **Sustainability** reveals how maize & blue make green
- 7 **Community** explores statewide outreach
- 8 **Dearborn • Flint** tells us what's happening at our other campuses
- 9 **Newsmakers** features the top stories of the year
- 10 **Major Projects** summarizes campus construction



The range of disciplines and their interrelationships throughout our campus are a mirror of the world we serve as a public university....

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Academics



## U-M scores big in national and international rankings



U-M garnered high marks again this year, coming in 1st among U.S. public universities in the *QS Top Universities*, and 14th overall in the world. Michigan also has 95 graduate programs ranked in the top 10 of *U.S. News & World Report's* best graduate schools rankings, placing U-M at #2 for public universities and #4 overall.

**1**  
1st among U.S. public universities,  
'QS Top Universities'  
1st public university

**12**  
Times Higher Education,  
World Reputation Rankings  
th overall

95 graduate programs  
in the  
**TOP 10**  
U.S. News and World Report  
Best Graduate Schools

## By the numbers

**65+**  
languages taught

**19**  
Schools  
+  
Colleges

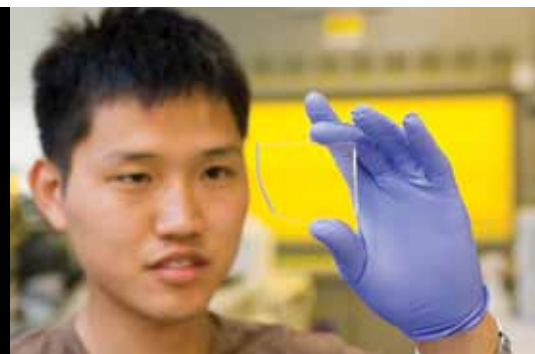
**3**  
genius grants  
awarded to U-M profs from  
MacArthur Foundation

**16:1**  
student to  
faculty ratio

**250**  
Degree  
Programs

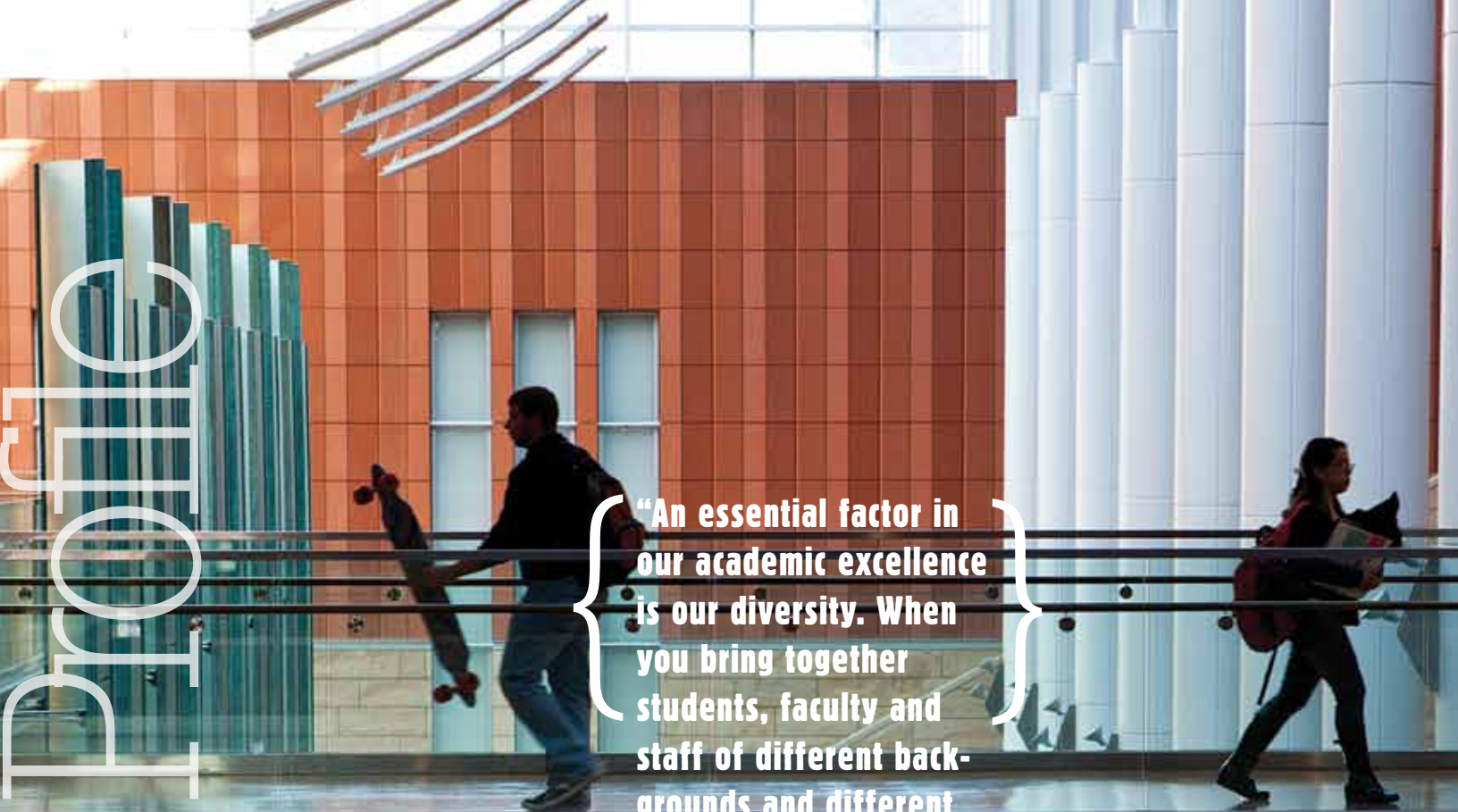
ACADEMICS

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# Student Profile



**"An essential factor in our academic excellence is our diversity. When you bring together students, faculty and staff of different backgrounds and different experiences, you create an intellectual experience that is unmatched in higher education."**

- Mary Sue Coleman, President





## New student profile

Enrollment at U-M's Ann Arbor campus remained at a record level for the third consecutive year in fall 2011 with 42,716 students, according to the Office of the Registrar.

Freshman applications for 2011 were up 25 percent to an all-time high of 39,584, an increase that is credited in part to the Common Application, which U-M joined in 2010–11. The university offered admission to 16,073 of the applicants, approximately the same number as the previous year.

## 2011 Fall Term Enrollment



	Undergraduate	Graduate/Professional	Total
ANN ARBOR	27,407	15,309	42,716
DEARBORN	7,405	1,550	8,955
FLINT	6,959	1,303	8,262
ALL CAMPUSES	41,771	18,162	59,933

## 2011–12 Degrees Granted



	Undergraduate	Graduate/Professional	Total
ANN ARBOR	6,490	5,660	12,150
DEARBORN	1,264	529	1,793
FLINT	414	1,075	1,489
ALL CAMPUSES	8,168	7,264	15,432

## Class of 2015 stats

**3.8** grade point average  
More than 34% had an ACT composite score between 31 and 36 compared to only 4% nationwide.

**19%** achieved 4.0

**39,584** freshman applications  
An all-time high, up 25%, which is credited in part to the Common Application

**\$25,204**  
 Cost of Attendance

Annual U-M tuition and required fees, room and board, books, and personal spending for a lower-division, full-time resident student

**\$10,242**  
 Need-Based Grants

Typical U-M grant award for a resident student with a family income of \$60,000–\$80,000

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**“Learning without borders.’ This is the University of Michigan and this is what we do best: immersive learning, service to society, sustainable practices and collaboration, all in a global setting.”**

- Mary Sue Coleman, President



## Global mission, global vision: U-M honored with Simon Internationalization Award



Michigan received a 2012 Senator Paul Simon Award  
for Comprehensive Internationalization, given by  
NAFSA: The Association of International Educators.

Named for the late Sen. Paul Simon (D-Ill.), the award  
honors outstanding and innovative achievements in  
campus internationalization.



U-M undergraduate and graduate students come from  
all 50 states of the U.S., as well as 122 other countries

5<sup>th</sup> public institution  
Ranked 5<sup>th</sup> among public research institutions,  
in numbers of INTERNATIONAL STUDENTS.  
Open Doors Report

8<sup>th</sup> nationally  
Ranked 8<sup>th</sup> nationally in numbers of  
INTERNATIONAL STUDENTS among public  
and private institutions. Open Doors Report

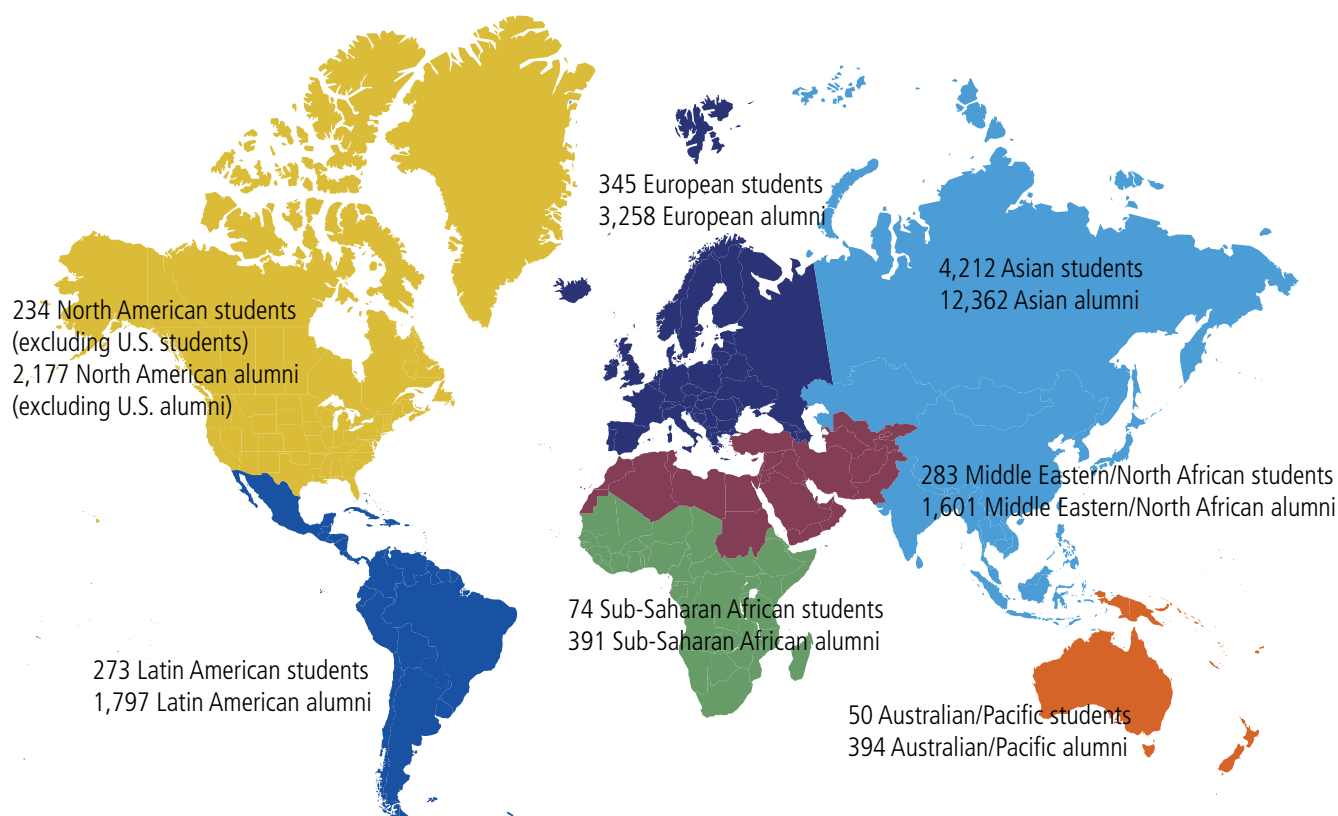
29 Fulbrights  
2011-2012 U-M had more students  
receiving Fulbright grants than any  
other U.S. institution.

1,655 INTERNATIONAL  
UNDERGRADUATE  
STUDENTS on the U-M  
Ann Arbor campus

3,869 INTERNATIONAL  
GRADUATE  
STUDENTS on the U-M  
Ann Arbor campus

GLOBAL

21>



**2011 U-M international student enrollment and alumni by world region**

# Health System

**More patients  
than ever, from  
every county in  
Michigan and  
beyond, turned  
to UMHS for  
research-based  
care in FY 2012.**







## Supporting superior healthcare

### MOTT AND VON VOIGTLANDER HOSPITALS OPEN

The new state-of-the-art hospitals show our commitment to providing outstanding healthcare to newborns, children, and women. The 1.1 million square feet of space includes 16 operating rooms, a 348-bed inpatient tower, a pediatric ER, and even a football-themed playspace. Clinical facilities include a blood and marrow transplant inpatient floor for children and adults with on-site infusion pharmacy and an entire floor for the Michigan Congenital Heart Center.

### THE STATE OF THE HEALTH SYSTEM: 2012

It was an eventful year for the U-M Health System, with more than 2 million patient appointments and hospital visits and an amazing patient satisfaction score of 90.9 percent. An expanded adult emergency department opened, and plans for further adult care expansions took shape. The Institute for Healthcare Policy and Innovation also opened its doors, and the first of its 400+ interdisciplinary researchers moved into their new home at the North Campus Research Complex. UMHS received \$464 million in research awards, and its entrepreneurial arm took in \$11 million in royalties in addition to 57 license agreements and three startups.

UMHS also continued to make strategic alliances with other healthcare entities, including the IHA physician group, the Michigan hospitals of Trinity Health (which includes the St. Joseph Mercy Health System), the Great Lakes Health Information Exchange, and Wayne County health services offices. These partnerships position UMHS for success in a new age of healthcare challenges.



**U-M Medical School #6 in the nation  
for NIH funding**



**UMHS adult care ranked 14th in the nation, 1st in  
the area (U.S. News & World Report, July 2011)**

**C.S. Mott Children's Hospital ranked nationally in  
all 10 specialties (U.S. News & World Report,  
June 2012)**



“Research at  
U-M is tightly  
coupled with  
our educational  
mission, and it  
is a critical  
investment in  
the future.”

- Stephen R. Forrest,  
Vice President for Research

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Research



## Research at Michigan: A commitment to the future

### U-M ANNUAL RESEARCH SPENDING GROWS TO \$1.27 BILLION

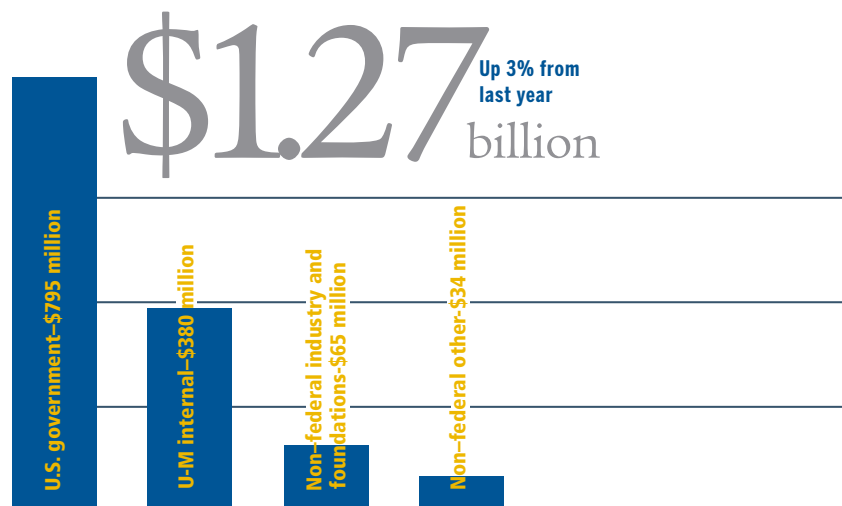
For the fourth straight year U-M surpassed the billion-dollar milestone. Over the last decade, total research expenditures have more than doubled. Steady growth in support from a wide range of sponsors is an indication of the value they see in investing in the people and ideas that drive our economic vitality.

### UMTRI, USDOT TEAM UP FOR \$25 MILLION "SAFETY PILOT" STUDY

The University of Michigan Transportation Research Institute (UMTRI) and the U.S. Department of Transportation are conducting a joint, \$25 million research project, which explores the potential of connected-vehicle systems. The 30-month "Safety Pilot" study, taking place in Ann Arbor, involves installing wireless communication devices on 3,000 cars, trucks, and buses, as well as along roads. Researchers estimate that the technology may be able to help reduce crashes by up to 80 percent.

**1** Ranked 1st among public universities in research volume. National Science Foundation's Center for Higher Education Statistics

**2** Ranked 2nd among all universities in research volume. National Science Foundation's Center for Higher Education Statistics



The federal government contributed \$795 million of the total, with \$380 million from U-M internal funds, and \$99 million from non-federal funds.

RESEARCH

25>

### STEM CELL LINES ADDED TO NIH REGISTRY

The first human embryonic cell line derived at U-M was added to the National Institutes of Health (NIH) registry, making the cells available for federally funded research. By year end, eight U-M cell lines, both normal and disease-specific, were registered.



### U-M RESEARCHERS HELP UNLOCK THE SECRETS OF THE UNIVERSE

Faculty and students from U-M's physics department played a key role in discovering the Higgs boson, a tiny particle that is central to understanding the origin of mass. The discovery was part of an on-going collaboration among 3,000 physicists from 38 countries to learn about the basic forces that have shaped the universe since its beginning.



A photograph of a group of children working in a garden. In the foreground, a girl with dark hair, wearing a red shirt, a blue headband, and blue sunglasses, is bent over, tending to plants in a raised garden bed. Behind her, other children are visible, some holding vegetables like corn. The garden is filled with various green plants, including leafy greens and what appear to be squash or pumpkin plants. The scene is outdoors, with sunlight filtering through the foliage.

# Sustainability

**Whether it's campus recycling programs, clean-energy research, or new undergraduate classes, Michigan is committed to sustainability.**



## How green was my campus



### NEW COMMITMENTS TO SUSTAINABILITY ON CAMPUS

In a broad green stroke across campus, U-M has invested \$14 million to achieve ambitious environmental goals. Efforts include cutting greenhouse gas emissions and waste, making the transportation system more efficient, protecting the Huron River, and promoting locally grown sustainable foods.

### DOW SUSTAINABILITY FELLOWSHIPS ANNOUNCED

U-M and The Dow Chemical Company will bring together 300 students from all areas of study in a new and unprecedented fellowship program. The company will provide a gift of \$10 million over six years to support the Dow Sustainability Fellows Program at U-M.

### ANNUAL SUSTAINABILITY REPORT SHOWS SUCCESS IN KEY AREAS

U-M continues to make progress in key areas of energy reduction, alternative transportation, and waste reduction, according to its 2011 annual sustainability report. Covering more than 170 environmental metrics—the most ever included in the five years of its existence—this report presents the university's impact on the environment while highlighting examples of stewardship and sustainability efforts taking place on the Ann Arbor campus.

### HYBRID BUSES ARRIVE ON CAMPUS

U-M debuted its first diesel-electric hybrid bus in January. Sporting a maize-and-blue color scheme and a new graphic treatment, the buses use a roof-mounted battery system to supplement their diesel engines, allowing for better fuel mileage and lowering emissions. Officials expect an improvement of 30 percent over a conventional bus. By the end of 2012, one in six buses on campus will be a hybrid.

“bike-friendly”



U-M voted one of the top “bike-friendly” campuses. (League of American Bicyclists)



1<sup>st</sup>  
diesel-electric hybrid bus on campus

# Community

Serving the  
public good  
is part of our  
culture at the  
university.

TO RICO

CANADA





## Community: Making a difference

### **GRAHAM FUNDS DETROIT SUSTAINABILITY PROJECTS**

The Graham Environmental Sustainability Institute is collaborating with Focus: HOPE on Detroit community development initiatives. UM-funded projects will incorporate social, economic, and environmental strategies to help develop a comprehensive plan for advancing the HOPE Village Initiative, a 100-block area immediately surrounding the Focus: HOPE campus near the border of Detroit and Highland Park. Each of the six selected U-M projects will receive \$25,000 to \$30,000 over the next 18 months. The initiative seeks to integrate Focus: HOPE's strengths in workforce development, early childhood education, and community development.

### **URC PROVIDES TALENT, INNOVATION**

The three University Research Corridor schools—Michigan State University, Wayne State University, and U-M—confer more than 3,600 degrees annually in auto-ready careers, and have spent more than \$300 million on auto-related research in the past five years, according to an independent analysis, "The URC's Contributions to Automotive Innovations." Conducted by Anderson Economic Group, the annual report quantifies and assesses industry sectors where the universities' research and development play a major role.

### **NEW SKILLS**

Teaching entrepreneurial skills to inner-city teachers is the goal of a first-of-its-kind course offered jointly by the College of Engineering's Center for Entrepreneurship (CfE) and School of Education. U-M students who are Teach For America Detroit Corps members will take part in the Education Entrepreneurship Workshop, taught by Moses Lee, assistant director for student ventures at the CfE.





The Dearborn  
and Flint  
campuses offer  
rich academic  
programs to  
students  
throughout  
the state.

# Dearborn • Flint

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## **Dearborn and Flint campuses**

### **DEARBORN**

#### **Science Building Renovations Approved**

Governor Rick Snyder signed a bill to approve a \$30 million capital outlay to help fund UM-Dearborn's Science Building renovation. The \$51 million project is already underway and in the design phase. The new building will improve energy efficiency, reduce operating costs, and minimize the university's carbon footprint.

#### **UM-Dearborn Unveils Recycling Program**

Coinciding with Earth Day, UM-Dearborn launched a campus-wide recycling program, which is expected to divert 1.4 million pounds of waste from landfills over a five-year period. The campus joins other leading universities in implementing single-stream recycling, which encourages recycling by simplifying the process.

### **FLINT**

#### **UM-Flint and Livingston County Schools Establish Dual Enrollment Educational Partnership**

UM-Flint is joining with Livingston County to offer students an opportunity to earn college credits while still in high school through the new Dual Enrollment Educational Partnership (DEEP) program. DEEP, an innovative, educational initiative, offers college courses to help jump-start students' higher education careers.

#### **UM-Flint Named Engaged Campus of the Year**

UM-Flint has been selected as the first recipient of the "Engaged Campus of the Year Award" presented by the Michigan Campus Compact. The award recognizes institutions of higher education for exemplary commitment to being an "engaged campus."





# NewsMakers

A live webstream from Burma, a record-smashing football game, and a visit by the president of the United States: just three of the Michigan stories that made news in the past year.







## **One for the record books:**

### **Michigan-Notre Dame under the lights**

"Michigan 35, Notre Dame 31" doesn't really do justice to it: the first-ever night game at Michigan Stadium, a record crowd of 114,804, and a come-from-behind victory for the Wolverines.

### **MCubed: a new way to fund research**

A first-of-its-kind, real-time research funding initiative puts university professors in charge of divvying up research dollars, in the purest form of peer review.

### **ArtsEngine awarded Mellon grant**

U-M's ArtsEngine will receive a three-year, \$500,000 grant to support a national effort to integrate artists and the creative practice into the culture of U.S. research universities.

### **Coursera: breaking new ground in online education**

Web-based classes with video lectures, interactive quizzes, and collaborative online forums will be available at no cost through coursera.org. U-M is one of four inaugural participating universities.

### **Live from Burma**

Named for WWII hero Raoul Wallenberg, U-M's Wallenberg Medal has been awarded to human-rights activists since 1990, when it went to Elie Wiesel. This year, Aung San Suu Kyi made history when she delivered the Lecture and Q&A online from her home in Burma.

### **Welcome, Mr. President**

Nearly two years after his 2010 commencement speech, President Barack Obama returned to campus and spoke to students, elected officials, and guests about education goals and containing college costs.

### **MABEL: the world's fastest robot**

It sounds like a science-fiction story, but it's science fact: with a peak pace of 6.8 mph, and knees, MABEL is believed to be the world's fastest bipedal robot.

### **New deans**

Alison Davis-Blake is the new Edward J. Frey Dean of the Stephen M. Ross School of Business. Gunalan Nadarajan started as Dean of the School of Art & Design. And Marie Lynn Miranda is the new Dean of the School of Natural Resources and Environment.

### **Solar car "Quantum" places 3rd in the world**

The rough Australian continent was no match for U-M's Solar Car team, which became the first American car to finish the World Solar Challenge, coming in 3rd with an average speed of 52 mph.

### **U-M's 'MINTS' initiative mints first company**

A U-M startup that markets next-gen computer memory is the recipient of U-M's first investment in one of its own startup companies, through the Michigan Investment in New Technology Startups (MINTS) program.



# Major Projects



Waiting area, C.S. Mott Hospital



CT Scan machine, C.S. Mott Hospital





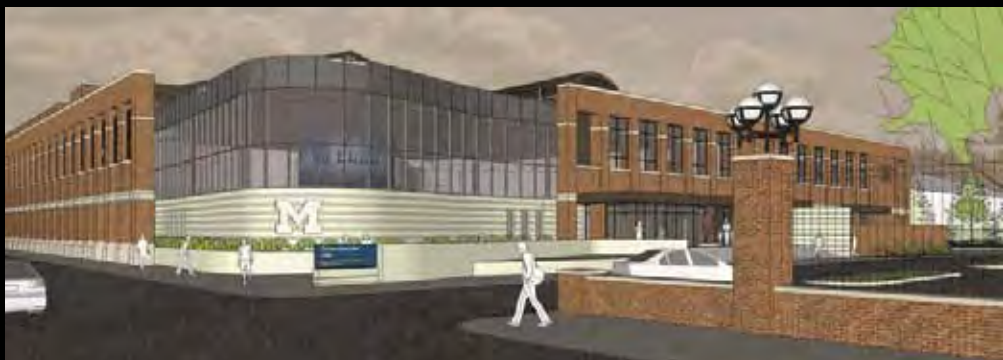
**From the new hospitals to the Crisler renovation to the Law School additions, our campus continues to grow.**

## Projects in planning

- George Granger Brown Memorial Laboratories Renovation
- Dearborn Science Building and Computer Information Science Building Renovation
- Flint Central Energy Plant Boiler Replacement
- Flint William R. Murchie Science Building Renovation
- Hutchins Hall and William W. Cook Legal Research Library Law School Renovation Phase II
- Institute for Social Research Addition
- North Hall Infrastructure Improvements
- School of Nursing New Building
- Glenn E. Schembechler Hall Entrance and Museum Renovation
- A. Alfred Taubman Health Sciences Library Renovation
- University of Michigan Hospitals and Health Centers Programs
  - Cancer Center Backfill Renovations
  - Cardiovascular Center Central Uninterruptible Power Supply
  - I-275 Corridor Clinic Expansion Leasehold Improvements
  - Livingston County Survival Flight Hangar Leasehold Improvements
  - C. S. Mott Children's Hospital, Von Voigtlander Women's Hospital, Maternal and Child Health Care Center, and James and Lynelle Holden Perinatal Research Laboratory, Adult Inpatient Capacity Expansion and UH South Office Renovation
  - A. Alfred Taubman Health Care Center Backfill Renovations (Levels 1 and 2)
  - A. Alfred Taubman Health Care Center Internal Medicine Renovation
  - University Hospital and A. Alfred Taubman Health Care Center Fire Alarm Upgrades
- Wall Street East Parking Structure



**Institute for Social Research Addition**



**Glenn E. Schembechler Hall Entrance and Museum Renovation**

## Projects in progress

**George Granger Brown Memorial Laboratories Mechanical Engineering Addition** | Work started April 2012 with an estimated completion date of September 2014. Financing is from the College of Engineering, gifts, investment proceeds, and a construction grant from the National Institute of Standards and Technology.

**Central Power Plant Distributed Control System Upgrades** | Work started January 2012 with an estimated completion date of December 2014. Financing is from utilities reserves.

**Crisler Center Expansion** | Work started December 2011 with an estimated completion date of March 2014. Financing is from the Athletic Department.

**East Quadrangle Renovation** | Work started February 2012 with an estimated completion date of September 2013. Financing is from Housing, the College of LSA, and investment proceeds.

**Flint Northbank Center Elevator Replacement** | Work started February 2012 with an estimated completion date of September 2013. Financing is from UM-Flint.

**Institute for Social Research Wing One Fire Suppression System** | Work started June 2011 with an estimated completion date of July 2012. Financing is from the Institute for Social Research and the Office of the Provost.

**Edward Henry Kraus Building Auditorium Renovation** | Work started April 2012 with an estimated completion date of September 2012. Financing is from the College of LSA and the Office of the Provost.

**The Lawyers' Club Building and John P. Cook Building Renovation** | Work started April 2012 with an estimated completion date of September 2013. Financing is from a gift, investment proceeds, and the Lawyers Club.

**Alice Crocker Lloyd Hall Renovation** | Work started February 2011 with an estimated completion date of September 2012. Financing is from Housing.

**Michigan Memorial Phoenix Laboratory Addition and Second Floor Renovation** | Work started August 2011 with an estimated completion date of June 2013. Financing is from investment proceeds, the Office of the Vice President for Research, and the College of Engineering.

**North Campus Support Facility** | Work started August 2011 with an estimated completion date of July 2012. Financing is from investment proceeds.

**Northwood Apartments I, II, and III Fire Alarm and Boiler Upgrades** | Work started March 2012 with an estimated completion date of September 2013. Financing is from Housing.

**University of Michigan Hospitals and Health Centers Programs** | Financing is from the Hospitals and Health Centers.

- **Med Inn Electrical Substation and Riser Upgrades** | Work started November 2011 with an estimated completion date of August 2012.

- **C. S. Mott Children's and Von Voigtlander Women's Hospitals Cardiac Catheterization Laboratory** | Work started January 2012 with an estimated completion date of December 2012.

- **Parkview Medical Center and Scott and Amy Prudden Turner Memorial Clinic Building Demolition** | Work started January 2012 with an estimated completion date of December 2012.

- **University Hospital Kitchen Renovations for Room Service Protocol** | Work started August 2011 with an estimated completion date of March 2013.

- **University Hospital Trauma Burn Unit Renovations** | Work started February 2012 with an estimated completion date of December 2012.

**Varsity Drive Building and Alexander G. Ruthven Museums Building Museum of Zoology Collection Relocation and Renovations** | Work started April 2010 with an estimated completion date of December 2012. Financing is from investment proceeds.

**Vera B. Baits Houses II Renewal** | Work started December 2011 with an estimated completion date of September 2013. Financing is from Housing.

**Yost Ice Arena Seating Replacement and Fan Amenities Improvement** | Work started February 2012 with an estimated completion date of December 2012. Financing is from the Athletic Department and gifts.

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**Wall Street East Parking Structure**



**Crisler Center Expansion**



## Projects completed

**Auxiliary Services Building Renovations for the School of Art & Design** | Completed September 2011. Financed by investment proceeds.

**Beal Avenue Water Main and North Campus Storm Relief System Upgrades** | Completed November 2011. Financed by utilities reserves.

**Burton Memorial Tower Façade and Bell Tower Repairs** | Completed December 2011. Financed by the general fund.

**Central Campus Area Utility Tunnel Refurbishment** | Completed November 2011. Financed by utilities reserves.

**Crisler Arena, Michigan Stadium, and Yost Ice Arena Scoreboard Replacement** | Completed September 2011. Financed by the Athletic Department.

**Crisler Arena Renovation** | Completed October 2011. Financed by the Athletic Department.

**James and Anne Duderstadt Center Air Barrier and Mechanical System Repairs** | Completed July 2011. Financed by the general fund.

**Flint Riverfront Building Leasehold Improvements for the School of Management** | Completed March 2012. Financed by Flint.

**Golf Practice Facility** | Completed September 2011. Financed by the Athletic Department and gifts.

**Edward Henry Kraus Building Molecular, Cellular and Developmental Biology Laboratory Renovations** | Completed October 2011. Financed by the College of LSA.

**Law School Academic Building and Hutchins Hall Law School Aikens Commons Addition** | Completed October 2011. Financed by gifts, investment proceeds, and the Law School.

**Clarence Cook Little Science Building Geological Sciences Laboratory Renovations** | Completed December 2011. Financed by the College of LSA.

**Medical Science Unit II Integrative Physiology Department Renovations** | Completed June 2012. Financed by the Medical School.

**Modern Languages Building Second Floor and Basement Renovation** | Completed August 2011. Financed by the College of LSA.

**North Campus Chiller Plant Expansion** | Completed July 2011. Financed by utilities reserves and the general fund.

**North Campus Research Complex Building 16 Renovation for Health Services Research** | Completed June 2012. Financed by the Medical School.

**William Davidson Player Development Center for Intercollegiate Basketball** | Completed October 2011. Financed by the Athletic Department and gifts.

**School of Social Work Building Atrium Level Renovations** | Completed September 2011. Financed by the School of Social Work.

**South Quadrangle Elevator Replacement** | Completed September 2011. Financed by Housing.

**University of Michigan Hospitals and Health Centers Programs** | Financed by the Hospitals and Health Centers.

- **C. S. Mott Children's and Von Voigtlander Women's Hospitals Replacement Project** | Completed November 2011. Financed by the Hospitals and Health Centers and gifts.
- **C. S. Mott Children's and Von Voigtlander Women's Hospitals Replacement Project Shell Space Completion Project** | Completed November 2011.
- **Domino's Farms Leasehold Improvements for Sleep Disorders Center** | Completed June 2012.
- **Eisenhower Corporate Park West Orthotics and Prosthetics Center Expansion** | Completed May 2012.
- **Multiple Buildings Pneumatic Tube System Upgrade** | Completed February 2012.
- **River Place Offices Leasehold Improvements for Ophthalmology** | Completed March 2012.
- **Simpson Circle Parking Structure Improvements** | Completed December 2011. Financed by the Hospitals and Health Centers and Parking.
- **University Hospital Emergency Department Expansion** | Completed March 2012.
- **University Hospital Emergency Power System Improvements** | Completed October 2011.
- **University Hospital Computed Tomography Angiography** | Completed December 2011.
- **University Hospital Medical Procedure Unit Expansion** | Completed June 2012.
- **University Hospital Radiation Oncology Simulator Replacement** | Completed February 2012.

**Wolverine Tower Renovations for Business and Finance** | Completed October 2011. Financed by Business and Finance.



**William Davidson Player Development Center for Intercollegiate Basketball**



**Michigan Memorial Phoenix Laboratory Addition**

# Management Responsibility for Financial Statements



THE UNIVERSITY OF MICHIGAN  
OFFICE OF THE EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER

3014 FLEMING ADMINISTRATION BUILDING  
ANN ARBOR, MICHIGAN 48109-1340  
(734) 764-7272 FAX (734) 936-8730

September 19, 2012

The management of the University of Michigan (the "University") is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements. The financial statements, presented on pages 57 to 83, have been prepared in conformity with accounting principles generally accepted in the United States of America and, as such, include amounts based on judgments and estimates by management.

The consolidated financial statements have been audited by the independent accounting firm PricewaterhouseCoopers LLP, which was given unrestricted access to all financial records and related data, including minutes of all meetings of the Board of Regents. The University believes that all representations made to the independent auditors during their audit were valid and appropriate. PricewaterhouseCoopers' audit opinion is presented on page 39.

The University maintains a system of internal controls over financial reporting, which is designed to provide reasonable assurance to the University's management and Board of Regents regarding the preparation of reliable published financial statements. Such controls are maintained by the establishment and communication of accounting and financial policies and procedures, by the selection and training of qualified personnel, and by an internal audit program designed to identify internal control weakness in order to permit management to take appropriate corrective action on a timely basis. There are, however, inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and the circumvention of controls.

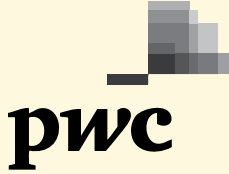
The Board of Regents, through its Finance, Audit and Investment Committee, is responsible for engaging the independent auditors and meeting regularly with management, internal auditors, and the independent auditors to ensure that each is carrying out their responsibilities and to discuss auditing, internal control, and financial reporting matters. Both internal auditors and the independent auditors have full and free access to the Finance, Audit and Investment Committee.

Based on the above, I certify that the information contained in the accompanying financial statements fairly presents, in all material respects, the financial condition, changes in net assets and cash flows of the University.

Timothy P. Slottow  
Executive Vice President and Chief Financial Officer



# Report of Independent Auditors



The Regents of the University of Michigan

In our opinion, the accompanying consolidated statements of net assets and the related consolidated statements of revenues, expenses and changes in net assets and of cash flows present fairly, in all material respects, the financial position of the University of Michigan (the "University") at June 30, 2012 and 2011, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying management's discussion and analysis on pages 40 through 56 is required by accounting principles generally accepted in the United States of America to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in the appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

*PricewaterhouseCoopers LLP*

September 19, 2012

**PricewaterhouseCoopers LLP, 1900 St. Antoine Street, Detroit, MI 48226**  
**T: (313) 394-6000, F: (313) 394-6555 [www.pwc.com/us](http://www.pwc.com/us)**

# 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, 2012 and 2011 and its activities for the three fiscal years ended June 30, 2012. 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 60,000 students and 7,300 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 \$15.7 billion and liabilities of \$4.9 billion at June 30, 2012, compared to assets of \$15.6 billion and liabilities of \$4.7 billion at June 30, 2011. Net assets, which represent the residual interest in the University's assets after liabilities are deducted, totaled \$10.8 billion at June 30, 2012 as compared to \$10.9 billion at June 30, 2011. Changes in net assets represent the University's results of operations and are summarized for the years ended June 30, 2012 and 2011 as follows:

(in millions)	2012	2011
Operating revenues and educational appropriations	\$ 5,391.4	\$ 5,186.3
Total operating and net interest expenses	5,878.9	5,463.8
	(487.5)	(277.5)
Net investment income	68.7	1,633.0
Gifts and other nonoperating revenues, net	247.7	205.8
(Decrease) increase in net assets	\$ (171.1)	\$ 1,561.3

Net assets decreased \$171 million in fiscal 2012 primarily due to a higher increase in operating and net interest expenses as compared to operating revenues and educational appropriations, combined with a significant decrease in net investment income from the prior year. Net assets increased \$1.56 billion in fiscal 2011 primarily due to net investment income.



In 2012, operating revenues and educational appropriations increased 4.0 percent, or \$205 million, while total operating and net interest expenses increased 7.6 percent, or \$415 million. Operating revenues increased 5.5 percent, or \$261 million, primarily due to increased patient care revenues and student tuition offset by decreased federal stimulus revenues, while state educational appropriations and federal Pell grants decreased 13.6 percent, or \$56 million.

Operating expenses increased 7.4 percent, or \$404 million, in 2012 due to growth in patient activity as well as activation costs and depreciation expense associated with significant capital projects. The new facility for the C.S. Mott Children's and Von Voigtlander Women's Hospitals was placed in service during the current fiscal year. In conjunction with the opening of this new facility and the approval of a renovation to the legacy facility, certain assets of the legacy facility with no future utility were written off. Several significant information technology systems were also implemented in 2012, including the first phase of an electronic medical record and patient billing system and a new donor and alumni relationship system. In addition, the University experienced increased self insurance costs due to higher incurred losses in medical professional liability and workers compensation. Net interest expense increased \$11 million in 2012, to \$37 million, primarily due to a decrease in the amount of capitalized interest on debt financed construction as a result of decreased construction in process.

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.

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, through its Daily and Monthly Portfolios, while the University's endowment is invested in an equity oriented long-term strategy, through its Long Term Portfolio. The success of the University's long-term investment strategy is evidenced by strong returns over sustained periods of time and the ability to limit losses in the face of challenging markets.

Net investment income totaled \$69 million and \$1.63 billion in 2012 and 2011, respectively. In 2012, net investment income included \$72 million from the Daily and Monthly Portfolios and \$3 million from non-pooled investments offset by a \$6 million loss in the Long Term Portfolio. In a difficult year for emerging markets, Europe and other non-U.S. equity markets, strong returns in U.S. fixed income investments, particularly for high-grade corporate and long-term U.S. government bonds, more than offset losses in the University's equity oriented investments. In 2011, net investment income included \$1.54 billion from the Long Term Portfolio, \$57 million from the Daily and Monthly Portfolios and \$36 million from non-pooled investments. Most asset classes experienced double digit positive returns in 2011, with equity and equity related investments across global markets performing particularly well.

Gifts and other nonoperating revenues increased 20 percent to \$248 million, due primarily to increased capital gifts.

# Management's Discussion and Analysis

(Unaudited)

## 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, 2012 and 2011 is summarized as follows:

(in millions)	2012	2011
Current assets	\$ 2,100	\$ 2,095
Noncurrent assets:		
Endowment, life income and other investments	7,949	8,122
Capital assets, net	5,338	5,193
Other	263	246
Total assets	15,650	15,656
Current liabilities	1,581	1,408
Noncurrent liabilities	3,316	3,324
Total liabilities	4,897	4,732
Net assets	\$ 10,753	\$ 10,924

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, 2012 and 2011, 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 and totaled \$2.1 billion at June 30, 2012 and 2011. Cash, cash equivalents and investments for operating activities totaled \$976 million at June 30, 2012, 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 \$1.6 billion and \$1.4 billion at June 30, 2012 and 2011, respectively.



## ENDOWMENT, LIFE INCOME AND OTHER INVESTMENTS

The composition of the University's endowment, life income and other investments at June 30, 2012 and 2011 is summarized as follows:

(in millions)	2012	2011
Endowment investments	\$ 7,691	\$ 7,835
Life income investments	101	105
Noncurrent portion of insurance and benefits obligations investments	157	182
	<u>\$ 7,949</u>	<u>\$ 8,122</u>

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 7,600 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 shares 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.

# Management's Discussion and Analysis

## (Unaudited)

Endowment spending rate distributions totaled \$270 million, \$266 million and \$255 million and withdrawals from funds functioning as endowment totaled \$39 million, \$44 million and \$5 million in 2012, 2011 and 2010, respectively. Total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 5.2 percent, 5.4 percent and 5.1 percent of the current year average fair value of the University Endowment Fund for 2012, 2011 and 2010, respectively. Over the past ten years, total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 5.4 percent.

In 2012, the University's endowment, life income and other investments decreased \$173 million, to \$7.9 billion at June 30, 2012. This decrease resulted primarily from endowment spending rate distributions and withdrawals from funds functioning as endowment in excess of new endowments from gifts and other sources, and from small net losses incurred in the equity oriented Long Term Portfolio.

### **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 \$591 million in 2012, as compared to \$635 million in 2011. 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 \$400 million, as well as debt proceeds of \$191 million. Construction in progress, which totaled \$227 million at June 30, 2012 and \$825 million at June 30, 2011, includes important projects for patient care, research, instruction, athletics and student residential life.

Renovation projects completed in 2012 include Alice Lloyd Hall. Like the extensive renovations to Mosher Jordan, Stockwell and Couzens residence halls in previous years, the infrastructure of the building was thoroughly upgraded, including high-speed network access, accessibility improvements, renovated bath facilities, and new plumbing, heating, cooling, ventilation and fire detection and suppression systems. In addition, energy conservation measures were implemented to improve the energy performance of the overall building, which was originally constructed in 1949. New spaces were created in the vacated dining areas, that are no longer needed since the Hill area Dining Center became operational in Fall 2008, for living-learning and academic initiatives, student interaction and creation of community.

New construction projects completed in 2012 include a new facility for C.S. Mott Children's Hospital and Von Voigtlander Women's Hospital to meet increasing patient demand and accommodate research, education and clinical care innovations. The new state-of-the art facility further enhances 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 totals approximately 1.1 million square feet. This new facility, whose construction commenced in fiscal 2007 and opened in December 2011, enables our world-renowned physicians and researchers to deliver world-class care and train tomorrow's generation of women's and children's physicians and nurses to go into practice with the most advanced experience possible.

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 Quadrangle, a new four-story academic and administrative building opened in 2012 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 now occupies the previously unused grassy area between Hutchins Hall and the Legal Research Building, and includes a main floor café and a lower level designed to facilitate student meetings and study groups. Life safety upgrades to Hutchins Hall and the Cook Library were also completed.



To address the need for more functional training and practice space for the men's and women's basketball programs, the William Davidson Player Development Center was completed in 2012. The Center connects to the east side of Crisler Arena and houses two basketball practice courts, team locker areas, strength and conditioning space, athletic medicine space and coaching and staff offices. At June 30, 2012, construction continued on a renovation and expansion of Crisler Arena which had only received minor renovations since its construction in 1967. The renovation will accommodate accessible seats, improve circulation and egress, increase restrooms and concessions and add other fan amenities, while the expansion will create new spectator entrances, retail spaces, ticketing areas and a private club space. This project is expected to be fully completed in Winter 2013.

Construction in process at June 30, 2012 also includes renovations of student residences at East Quadrangle and the Law School. The renovation of the East Quadrangle residence hall is part of the University's residential life initiatives, a comprehensive multi-year plan to improve and expand the student residential experience. The renovation will also reconfigure spaces to create new study and gathering spaces for students and create synergies between the academic and residential programs in the building. In addition, the infrastructure of the building will be thoroughly upgraded and energy conservation measures will be implemented to improve the energy performance of the overall building, which was originally constructed in 1940. This project is expected to be completed by Fall 2013.

One of the largest gifts ever made to the Law School will help revitalize living spaces within the student-housing portion of the Law Quadrangle. This renovation will upgrade student rooms and other living areas, which were originally constructed in 1924, while preserving the historic Gothic exteriors. This project is expected to be completed by Fall 2013.

The unoccupied portion of the North Campus Research Complex, which was originally acquired from Pfizer in 2009, is classified as property held for future use and totaled \$47 million and \$54 million at June 30, 2012 and 2011, respectively. This complex supports the growth of the University's translational research initiatives through the population of office space, laboratories and other facilities over the next several years. At June 30, 2012, the complex has seven translational science initiatives bringing together hundreds of research team members from many disciplines and schools for work in cardiovascular research, translational oncology, healthcare policy and innovation, emergency medicine, computational medicine and bioinformatics, distributed health technologies and biointerfaces. In addition, the complex now has nine shared facilities for scientists' use including bioinformatics analysis, DNA sequencing, and microscopy and image analysis.

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. In February 2012, 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. 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 fund-raising 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, 2012, 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	\$ 91	\$ 108	\$ 136	\$ 63
Bonds and Notes:				
General revenues	1,242	219	40	1,421
Hospital revenues	295		15	280
Faculty Group Practice revenues	62		2	60
Student residences revenues	2			2
	<u>\$ 1,692</u>	<u>\$ 327</u>	<u>\$ 193</u>	<u>\$ 1,826</u>

# Management's Discussion and Analysis

(Unaudited)

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, 2012 and 2011, commercial paper totaled \$63 million and \$91 million, respectively, and is included in current liabilities.

During 2012, consistent with capital and debt financing plans, the University issued \$115 million of variable rate tax-exempt revenue bonds (Series 2012A and Series 2012B) and \$90 million of fixed-rate tax-exempt general revenue bonds (Series 2012C) with a net original issue premium of \$14 million. Bond proceeds, which totaled \$219 million, were utilized to convert \$119 million of commercial paper to long-term debt and provide \$100 million for capital projects and debt issuance costs.

The University maintains a combination of fixed and variable rate debt, which totaled \$1.8 billion and \$1.7 billion at June 30, 2012 and 2011, respectively. The University's fixed and variable rate debt at June 30, 2012 and 2011 is summarized as follows:

(in millions)	2012	2011
Variable rate:		
Commercial paper	\$ 63	\$ 91
Demand bonds	847	747
Fixed rate bonds	916	854
	<u>\$ 1,826</u>	<u>\$ 1,692</u>

In 2012, 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 2.3 percent in 2012 and 2.5 percent in 2011, 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 \$37 million in 2012 and \$26 million in 2011, while capitalized interest on debt financed construction in progress totaled \$6 million and \$18 million in 2012 and 2011, 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 four 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 \$1.67 billion and \$1.64 billion at June 30, 2012 and 2011, 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 \$263 million and \$239 million at June 30, 2012 and 2011, 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 \$441 million as of June 30, 2012. 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, 2012, the recorded liability for net postemployment benefits obligations totaled \$1.67 billion and the actuarial accrued liability totaled \$1.27 billion. The University amortizes changes in actuarial assumptions, plan design and experience gains and losses over a ten 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.

## 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, 2012 and 2011 is summarized as follows:

(in millions)	2012	2011
Invested in capital assets, net of related debt	\$ 3,598	\$ 3,575
Restricted:		
Nonexpendable:		
Permanent endowment corpus	1,346	1,279
Expendable:		
Net appreciation of permanent endowments	1,193	1,312
Funds functioning as endowment	1,597	1,652
Restricted for operations and other	493	503
Unrestricted	2,526	2,603
	<u>\$ 10,753</u>	<u>\$ 10,924</u>

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 \$23 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 \$67 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 \$3.3 billion at June 30, 2012, as compared to \$3.5 billion at June 30, 2011.

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, 2012 and 2011 totaled \$2.5 billion and \$2.6 billion, respectively. At June 30, 2012, unrestricted net assets included funds functioning as endowment of \$3.5 billion offset by unfunded obligations for postemployment benefits of \$1.7 billion. 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. Unrestricted net assets also included other net resources of \$700 million at June 30, 2012 and 2011.

# Management's Discussion and Analysis

(Unaudited)

## 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, 2012 is summarized as follows:

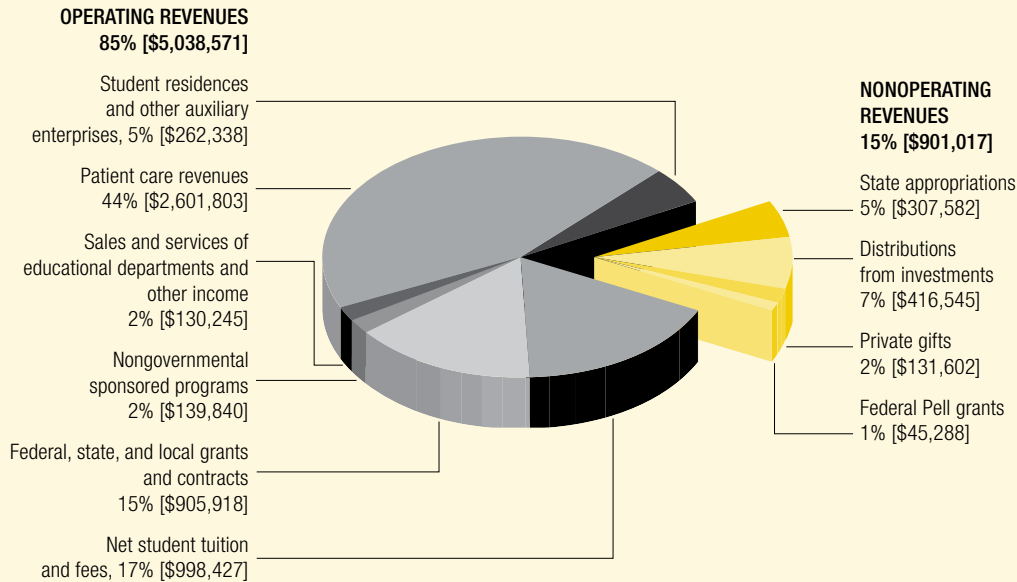
(in millions)	2012	2011	2010
Operating revenues:			
Student tuition and fees, net of scholarship allowances	\$ 998.4	\$ 915.7	\$ 863.9
Sponsored programs	1,045.8	1,072.9	990.3
Patient care revenues, net	2,601.8	2,411.1	2,310.8
Other	392.6	378.1	372.1
	5,038.6	4,777.8	4,537.1
Operating expenses	5,842.1	5,437.8	5,218.8
Operating loss	(803.5)	(660.0)	(681.7)
Nonoperating and other revenues (expenses):			
State educational appropriations	307.6	361.9	362.1
State fiscal stabilization funds			10.1
Federal Pell grants	45.3	46.7	39.9
Private gifts for operating activities	131.6	127.8	105.2
Net investment income	68.7	1,633.0	796.4
Interest expense, net	(45.1)	(33.1)	(30.0)
Federal subsidies for interest on Build America Bonds	8.3	7.1	3.3
State capital appropriations	0.1	0.8	2.0
Endowment and capital gifts and grants	107.6	82.3	88.7
Other	8.3	(5.2)	2.4
Nonoperating and other revenues (expenses), net	632.4	2,221.3	1,380.1
(Decrease) increase in net assets	(171.1)	1,561.3	698.4
Net assets, beginning of year	10,924.3	9,363.0	8,664.6
Net assets, end of year	\$ 10,753.2	\$ 10,924.3	\$ 9,363.0

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, which include instruction, patient care and research.

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, 2012 (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.

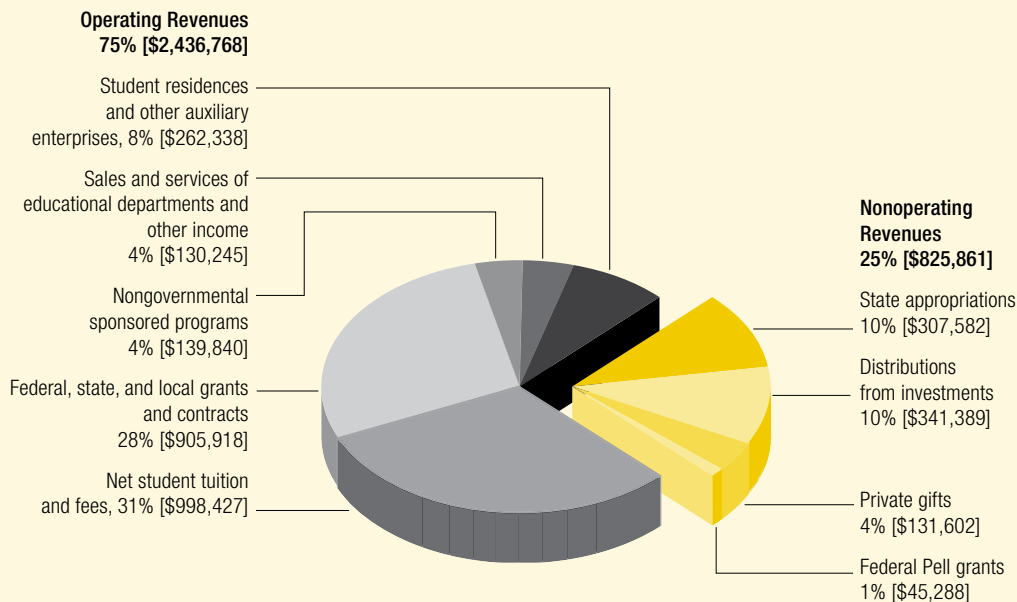


## FISCAL YEAR 2012 REVENUES FOR OPERATING ACTIVITIES



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, 2012 (amounts are presented in thousands of dollars).

## FISCAL YEAR 2012 REVENUES FOR OPERATING ACTIVITIES EXCLUDING REVENUES FROM THE UNIVERSITY'S HEALTH SYSTEM



# Management's Discussion and Analysis

## (Unaudited)

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 state appropriations increased 2 percent, or \$28 million, to \$1.31 billion in 2012, as compared to 4 percent, or \$52 million, to \$1.28 billion in 2011.

Downturns in state of Michigan tax revenues continue to put pressure on the state budget. In 2012, the University's state educational appropriations were reduced by 15 percent, or \$54 million, to \$308 million, the largest cut in state appropriations in the University's history. In 2011, the University's state educational appropriations were reduced by \$268,000, to \$362 million.

To maintain academic excellence and offset reduced state appropriations, net student tuition and fees revenue increased 9 percent in 2012 and 6 percent in 2011. For the three years ended June 30, 2012, net student tuition and fees revenue consisted of the following components:

(in millions)	2012	2011	2010
Student tuition and fees	\$ 1,269.7	\$ 1,177.9	\$ 1,097.5
Scholarship allowances	(271.3)	(262.2)	(233.6)
	<u>\$ 998.4</u>	<u>\$ 915.7</u>	<u>\$ 863.9</u>

In 2012, net student tuition and fees revenue increased 9 percent, or \$83 million, to \$998 million, which reflects an 8 percent, or \$92 million, increase in gross tuition and fee revenues offset by a 3 percent, or \$9 million increase in scholarship allowances. Tuition rate increases in 2012 were 6.7 percent for resident undergraduate students, 4.9 percent for nonresident undergraduate students and 4.9 percent for most graduate students on the Ann Arbor campus, with a 6.9 percent tuition rate increase for undergraduate and graduate students on the Dearborn campus, and a 6.8 percent and 4.9 percent tuition rate increase for Flint campus undergraduate and graduate students, respectively. The University also experienced moderate growth in the number of students, particularly nonresident students.

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.

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

In absorbing this year's historic cut in state funding, the University has been able to avoid the severe cuts and double digit tuition increases experienced elsewhere in the country because of a prudent long-term plan which anticipated the realities of the state's economy. The University's plan includes an ongoing commitment to cost containment and reallocating resources to the highest priorities to provide support for innovative new academic initiatives to maintain academic excellence and help students keep pace with the ever evolving needs of society.

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 \$132 million in 2012, as compared to \$128 million in 2011 and \$105 million in 2010.



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, with a significant portion related to federal research. Revenues for sponsored programs decreased 3 percent, or \$27 million, to \$1.0 billion in 2012, as compared to an increase of 8 percent, or \$83 million, to \$1.1 billion in 2011, primarily due to the spend down of federal stimulus awards from the American Recovery and Reinvestment Act of 2009. Federal stimulus revenue decreased \$58 million to \$59 million in 2012 and increased \$58 million, to \$117 million in 2011.

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 8 percent, or \$191 million, to \$2.6 billion in 2012, as compared to an increase of 4 percent, or \$100 million, to \$2.4 billion in 2011. The increased revenues for both years primarily resulted from a growth in both out-patient and inpatient volume, as well as increased reimbursement rates from third party payers.

Net investment income totaled \$69 million in 2012, as compared to \$1.6 billion and \$796 million in 2011 and 2010, respectively. In 2012, a difficult year for emerging markets, Europe and other non-U.S. equity markets, strong returns in U.S. fixed income investments, particularly for high-grade corporate and long-term U.S. government bonds, more than offset losses in the University's equity oriented investments. Financial markets rebounded strongly in 2011 and 2010 from the losses in 2009, with most asset classes experiencing double digit positive returns. Equity and equity related investments across global markets performed particularly well in 2011 and 2010. In addition, the real estate segment of the University's investment portfolio experienced positive returns in 2012 and 2011 after losses in 2010.

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.

Endowment and capital gifts and grants totaled \$108 million in 2012 as compared to \$82 million and \$89 million in 2011 and 2010, respectively, with the increase in 2012 due primarily to increased capital gifts. Private gifts for permanent endowment purposes totaled \$56 million in 2012, as compared to \$57 million in 2011 and \$60 million in 2010. Capital gifts and grants totaled \$52 million in 2012, as compared to \$25 million in 2011 and \$29 million in 2010. 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, Law School, Stephen M. Ross School of Business, Intercollegiate Athletics, College of Engineering and Museum of Art current and planned capital projects.

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 65 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, 2012 is as follows:

(in millions)	2012		2011		2010	
Operating:						
Compensation and benefits	\$ 3,804.3	65%	\$ 3,633.8	66%	\$ 3,529.3	66%
Supplies and services	1,473.7	25	1,299.6	24	1,215.6	24
Depreciation	443.1	7	390.1	7	360.1	7
Scholarships and fellowships	121.0	2	114.3	2	113.8	2
	5,842.1	99	5,437.8	99	5,218.8	99
Nonoperating:						
Interest, net	36.8	1	26.0	1	26.7	1
	\$ 5,878.9	100%	\$ 5,463.8	100%	\$ 5,245.5	100%

# Management's Discussion and Analysis

## (Unaudited)

The University is committed to recruiting and retaining outstanding faculty and staff and the compensation package is one way to successfully compete with peer institutions and nonacademic employers. The resources expended for compensation and benefits increased 5 percent, or \$171 million, to \$3.8 billion in 2012, as compared to a 3 percent, or \$105 million, increase to \$3.6 billion in 2011. Of the 2012 increase, compensation increased 6 percent, to \$2.9 billion, and employee benefits increased 2 percent, to \$870 million. During 2012, nursing and other health professionals were added to support higher patient volume levels associated with the opening of the new C.S. Mott Children's Hospital and Von Voigtlander Women's Hospital. For 2011, compensation increased 4 percent, to \$2.8 billion, and employee benefits increased less than 1 percent, to \$854 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 a unique position to utilize internal experts to advise and guide its health care and drug plans. For example, the Pharmacy Benefits Advisory Committee, which consists of internal experts including Health System physicians, School of Pharmacy faculty and an on-staff pharmacist, monitors the safety and effectiveness of covered medications as well as optimizes appropriate prescribing, dispensing and cost effective use of prescription drugs. The University also actively promotes and manages generic drug utilization and has achieved an 82 percent generic dispensing rate in 2012, as compared to 76 percent in 2011 and 72 percent in 2010.

In addition, the University utilizes 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 2012, the University substantially completed a two-year phase in of a new health benefits cost sharing program. 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 are 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 was 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.

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 twenty 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 twenty 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.



The MHealthy initiative is a university-wide effort to improve the health and well-being of faculty, staff and their dependents by creating a culture of health, reducing health risks in our population, and containing health related costs. During 2012, approximately 20,000 employees completed the annual health questionnaire, of which nearly 18,000 also completed a wellness screening. Since the inception of the MHealthy initiative in 2009, over 70 percent of employees have completed a health assessment and participated in at least one qualifying health and wellness program. A three-year evaluation of the program's impact was completed in 2012 by faculty researchers from the Michigan Institute for Clinical and Health Research and the University's Health Management Research Center. Faculty and staff who participated all three years showed statistically significant improvement in their risk levels, with the number of high risk individuals decreasing and the number of low risk individuals increasing.

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 13 percent, or \$174 million, to \$1.5 billion in 2012, primarily due to growth in patient activity as well as activation costs associated with significant capital projects. The new facility for the C.S. Mott Children's and Von Voigtlander Women's Hospitals was placed in service during the current fiscal year and the University implemented several significant information technology systems, including the first phase of an electronic medical record and patient billing system and a new donor and alumni relationship system. In addition, the University experienced increased self insurance costs due to higher incurred losses in medical professional liability and workers compensation. Supplies and services expenses increased 7 percent, or \$84 million, to \$1.3 billion in 2011, primarily due to increases in patient care related expenses and sponsored research activities offset by aggressive cost cutting and productivity gains.

Depreciation expense increased 14 percent, or \$53 million, to \$443 million in 2012, as compared to an 8 percent, or \$30 million, increase to \$390 million in 2011. Significant capital projects that were completed during 2012 include a new facility for the C.S. Mott Children's and Von Voigtlander Women's Hospitals, renovation to Alice Lloyd Hall, and the new William Davidson Player Development Center. In addition, the remaining net book value of certain capital assets of the legacy children and women's hospitals that were deemed to have no future utility were written off in 2012 based on current renovation plans for that facility.

Net interest expense increased \$11 million in 2012 to \$37 million, from \$26 million in 2011 and \$27 million in 2010. The increase in 2012 primarily resulted from a decrease in the amount of capitalized interest on debt financed construction due to decreased construction in process.

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, 2012 is as follows:

(in millions)	2012		2011		2010	
Operating:						
Instruction	\$	892.5	15%	\$	853.1	16%
Research		718.8	12		733.5	13
Public service		129.6	2		131.5	2
Institutional and academic support		504.5	9		486.3	9
Auxiliary enterprises:						
Patient care		2,532.4	43		2,285.2	42
Other		215.6	4		168.5	3
Operations and maintenance of plant		284.6	5		275.3	5
Depreciation		443.1	7		390.1	7
Scholarships and fellowships		121.0	2		114.3	2
		5,842.1	99		5,437.8	99
Nonoperating:						
Interest, net		36.8	1		26.0	1
	\$	5,878.9	100%	\$	5,463.8	100%
					\$	5,245.5
						100%

# Management's Discussion and Analysis

(Unaudited)

Instruction expenses increased 5 percent, or \$42 million, to \$893 million in 2012, from \$851 million in 2010. 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 \$1.27 billion in 2012, as compared to \$1.24 billion in 2011 and \$1.14 billion in 2010. This represents an increase of 12 percent, or \$133 million, from 2010 to 2012 and includes the impact of stimulus funds from the American Recovery and Reinvestment Act of 2009.

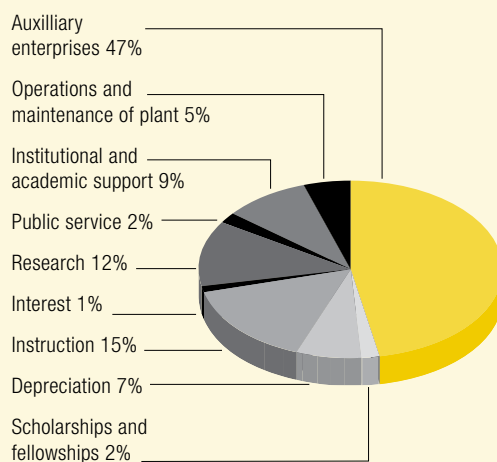
Patient care expenses increased 11 percent, or \$247 million, to \$2.5 billion in 2012, from \$2.3 billion in 2011. This increase is the result of increased patient activity from the opening of the new children and women's hospital facility, including costs of staffing, medical supplies and pharmaceuticals. Patient care expenses increased 5 percent, or \$103 million, to \$2.3 billion in 2011, from \$2.2 billion in 2010.

Total scholarships and fellowships provided to students aggregated \$411 million in 2012, as compared to \$395 million in 2011 and \$365 million in 2010, an increase of 13 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, 2012 are summarized as follows:

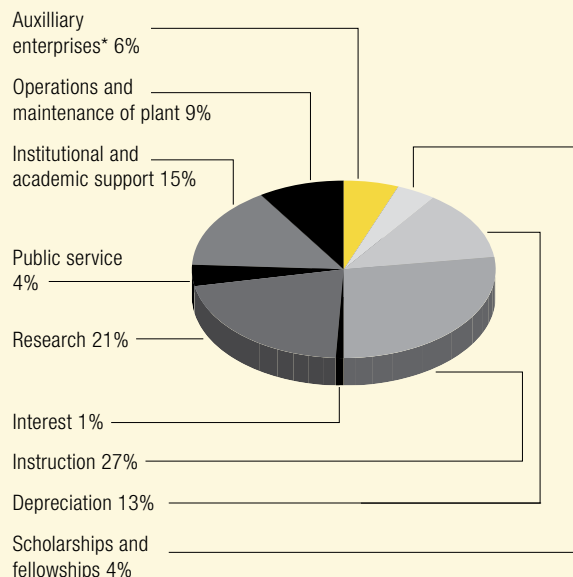
(in millions)	2012	2011	2010
Paid directly to students	\$ 121.0	\$ 114.3	\$ 113.8
Applied to tuition and fees	271.3	262.2	233.6
Applied to University Housing	19.0	18.2	17.4
	<u>\$ 411.3</u>	<u>\$ 394.7</u>	<u>\$ 364.8</u>

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

## FISCAL YEAR 2012 EXPENSES BY FUNCTION



## FISCAL YEAR 2012 EXPENSES BY FUNCTION EXCLUDING EXPENSES FROM THE UNIVERSITY'S HEALTH SYSTEM



\*Excludes expenses from the University's Health System of \$2.5 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, 2012 and 2011 is as follows:

(in millions)	2012	2011
Cash received from operations	\$ 5,011.9	\$ 4,806.5
Cash expended for operations	(5,332.5)	(5,020.5)
Net cash used in operating activities	(320.6)	(214.0)
Net cash provided by investing activities	141.3	176.5
Net cash used in capital and related financing activities	(436.2)	(441.7)
Net cash provided by noncapital financing activities	537.7	601.1
Net (decrease) increase in cash and cash equivalents	(77.8)	121.9
Cash and cash equivalents, beginning of year	316.5	194.6
Cash and cash equivalents, end of year	\$ 238.7	\$ 316.5

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.

The anticipated 2.7 percent increase in state educational appropriations in fiscal 2013 follows a 15 percent cut in state funding in fiscal 2012. To support the University's commitment to both academic excellence and accessibility, the University's budget for fiscal 2013 includes a moderate increase in tuition rates along with an increased investment in financial aid for undergraduates. Resident undergraduate tuition on the Ann Arbor campus will increase 2.8 percent and the University maintains a commitment to meet the full demonstrated financial need of resident undergraduate students with a 10.1 percent increase in centrally awarded financial aid. Nonresident undergraduate tuition will increase 3.5 percent, while most graduate and professional rates will increase 3.0 percent. Resident undergraduate tuition on the Dearborn and Flint campuses will increase 3.7 percent and 3.6 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.

# Management's Discussion and Analysis

## (Unaudited)

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 \$780 million at June 30, 2012. Funding for these projects is anticipated to include \$728 million from gifts, grants and net assets designated for capital purposes as well as future borrowings and \$52 million from the utilization of unexpended debt proceeds. Economic pressures are expected to affect the State's future support.

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, and affirmed by the Supreme Court, 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.



# Financial Statements

## Consolidated Statement of Net Assets

	June 30,	
(in thousands)	2012	2011
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	\$ 238,690	\$ 316,534
Investments for operating activities	737,384	664,197
Investments for capital activities	388,637	369,687
Investments for student loan activities	55,706	50,162
Accounts receivable, net	494,787	452,611
Current portion of notes and pledges receivable, net	59,553	58,586
Current portion of prepaid expenses and other assets	78,254	82,435
Cash collateral held by agent	47,200	100,600
Total Current Assets	2,100,211	2,094,812
Noncurrent Assets:		
Endowment, life income and other investments	7,948,955	8,122,450
Notes and pledges receivable, net	196,692	194,359
Prepaid expenses and other assets	66,718	51,340
Capital assets, net	5,337,664	5,193,173
Total Noncurrent Assets	13,550,029	13,561,322
<b>Total Assets</b>	<b>\$ 15,650,240</b>	<b>\$ 15,656,134</b>
<b>Liabilities and Net Assets</b>		
Current Liabilities:		
Accounts payable	\$ 195,055	\$ 167,153
Accrued compensation and other	350,508	367,769
Deferred revenue	200,966	193,801
Current portion of insurance and benefits reserves	84,155	72,539
Current portion of obligations for postemployment benefits	56,131	53,638
Commercial paper and current portion of bonds payable	135,193	147,553
Long-term bonds payable subject to remarketing, net	482,202	274,895
Collateral held for securities lending	47,200	100,600
Deposits of affiliates and others	29,988	30,439
Total Current Liabilities	1,581,398	1,408,387
Noncurrent Liabilities:		
Accrued compensation	68,498	70,190
Insurance and benefits reserves	102,821	93,337
Obligations for postemployment benefits	1,615,433	1,583,014
Obligations under life income agreements	44,056	46,219
Government loan advances	91,211	90,904
Bonds payable	1,208,869	1,270,017
Deposits of affiliates and other	184,757	169,804
Total Noncurrent Liabilities	3,315,645	3,323,485
Total Liabilities	4,897,043	4,731,872
Net Assets:		
Invested in capital assets, net of related debt	3,597,540	3,574,878
Restricted:		
Nonexpendable	1,345,859	1,279,058
Expendable	3,283,639	3,467,232
Unrestricted	2,526,159	2,603,094
Total Net Assets	10,753,197	10,924,262
<b>Total Liabilities and Net Assets</b>	<b>\$ 15,650,240</b>	<b>\$ 15,656,134</b>

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

# Financial Statements

## Consolidated Statement of Revenues, Expenses and Changes in Net Assets

(in thousands)	Year Ended June 30,	
	2012	2011
<b>Operating Revenues</b>		
Student tuition and fees	\$ 1,269,703	\$ 1,177,897
Less scholarship allowances	271,276	262,181
Net student tuition and fees	998,427	915,716
Federal grants and contracts	901,764	930,436
State and local grants and contracts	4,154	4,464
Nongovernmental sponsored programs	139,840	138,007
Sales and services of educational departments	127,473	124,235
Auxiliary enterprises:		
Patient care revenues (net of provision for bad debts of \$105,618 in 2012 and \$89,466 in 2011)	2,601,803	2,411,131
Student residence fees (net of scholarship allowances of \$19,201 in 2012 and \$18,212 in 2011)	94,134	90,232
Other revenues	168,204	160,727
Student loan interest income and fees	2,772	2,818
<b>Total Operating Revenues</b>	<b>5,038,571</b>	<b>4,777,766</b>
<b>Operating Expenses</b>		
Compensation and benefits	3,804,225	3,633,765
Supplies and services	1,473,665	1,299,651
Depreciation	443,132	390,071
Scholarships and fellowships	121,040	114,316
<b>Total Operating Expenses</b>	<b>5,842,062</b>	<b>5,437,803</b>
Operating loss	(803,491)	(660,037)
<b>Nonoperating Revenues (Expenses)</b>		
State educational appropriations	307,582	361,879
Federal Pell grants	45,288	46,669
Private gifts for other than capital and endowment purposes	131,602	127,751
Net investment income	68,650	1,632,968
Interest expense, net	(45,096)	(33,094)
Federal subsidies for interest on Build America Bonds	8,258	7,119
<b>Total Nonoperating Revenues, Net</b>	<b>516,284</b>	<b>2,143,292</b>
(Loss) income before other revenues (expenses)	(287,207)	1,483,255
<b>Other Revenues (Expenses)</b>		
State capital appropriations	100	843
Capital gifts and grants	51,934	24,907
Private gifts for permanent endowment purposes	55,742	57,451
Other	8,366	(5,182)
<b>Total Other Revenues, Net</b>	<b>116,142</b>	<b>78,019</b>
(Decrease) increase in net assets	(171,065)	1,561,274
Net Assets, Beginning of Year	10,924,262	9,362,988
<b>Net Assets, End of Year</b>	<b>\$ 10,753,197</b>	<b>\$ 10,924,262</b>

## Consolidated Statement of Cash Flows

(in thousands)	Year Ended June 30,	
	2012	2011
<b>Cash Flows from Operating Activities</b>		
Student tuition and fees	\$ 1,003,383	\$ 919,040
Federal, state and local grants and contracts	899,174	932,002
Nongovernmental sponsored programs	149,902	136,619
Sales and services of educational departments and other	295,671	289,242
Patient care revenues	2,549,627	2,419,524
Student residence fees	93,892	90,448
Payments to employees	(2,962,246)	(2,772,856)
Payments for benefits	(806,769)	(814,083)
Payments to suppliers	(1,427,728)	(1,307,883)
Payments for scholarships and fellowships	(121,025)	(114,292)
Student loans issued	(14,761)	(11,460)
Student loans collected	17,497	16,847
Student loan interest and fees collected	2,772	2,818
<b>Net Cash Used in Operating Activities</b>	<b>(320,611)</b>	<b>(214,034)</b>
<b>Cash Flows from Investing Activities</b>		
Interest and dividends on investments, net	55,934	68,488
Proceeds from sales and maturities of investments	3,583,260	3,000,798
Purchases of investments	(3,704,732)	(2,785,120)
Net decrease (increase) in cash equivalents from noncurrent investments	209,804	(125,176)
Net (decrease) increase in deposits of affiliates and others	(3,002)	17,541
<b>Net Cash Provided by Investing Activities</b>	<b>141,264</b>	<b>176,531</b>
<b>Cash Flows from Capital and Related Financing Activities</b>		
State capital appropriations	100	873
Private gifts and other receipts	58,056	35,395
Proceeds from issuance of capital debt	326,730	305,447
Principal payments on capital debt	(189,366)	(114,251)
Interest payments on capital debt, net of capitalized interest	(47,895)	(33,643)
Federal subsidies for Build America Bonds interest	8,258	6,296
Payments for bond refunding and related costs	(650)	(1,240)
Purchases of capital assets, including capitalized interest	(592,357)	(641,718)
Proceeds from sales of capital assets	890	1,129
<b>Net Cash Used in Capital and Related Financing Activities</b>	<b>(436,234)</b>	<b>(441,712)</b>
<b>Cash Flows from Noncapital Financing Activities</b>		
State educational appropriations	317,454	361,928
State fiscal stabilization funds		4,720
Federal Pell grants	45,288	46,669
Private gifts and other receipts	177,698	188,533
Student direct lending receipts	371,963	360,476
Student direct lending disbursements	(372,703)	(358,981)
Amounts received for annuity and life income funds	4,886	4,502
Amounts paid to annuitants and life beneficiaries and related expenses	(6,849)	(6,743)
<b>Net Cash Provided by Noncapital Financing Activities</b>	<b>537,737</b>	<b>601,104</b>
Net (decrease) increase in cash and cash equivalents	(77,844)	121,889
Cash and Cash Equivalents, Beginning of Year	316,534	194,645
<b>Cash and Cash Equivalents, End of Year</b>	<b>\$ 238,690</b>	<b>\$ 316,534</b>

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.



# Financial Statements

## Consolidated Statement of Cash Flows, continued

(in thousands)	Year Ended June 30,	
	2012	2011
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	\$ (803,491)	\$ (660,037)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation expense	443,132	390,071
Changes in assets and liabilities:		
Accounts receivable, net	(48,579)	7,935
Prepaid expenses and other assets	(7,199)	(10,853)
Accounts payable	36,526	(335)
Accrued compensation and other	(4,177)	10,658
Deferred revenue	7,165	9,379
Insurance and benefits reserves	21,100	10,604
Obligations for postemployment benefits	34,912	28,544
Net cash used in operating activities	\$ (320,611)	\$ (214,034)

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# Notes to Consolidated Financial Statements

June 30, 2012 and 2011

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

**Organization and Basis of Presentation:** The University of Michigan (the "University") is a state-supported institution with an enrollment of approximately 60,000 students on its three campuses. The financial statements include the individual schools, colleges and departments, the University of Michigan Hospitals and Health Centers, Michigan Health Corporation (a wholly-owned corporation created to pursue joint venture and managed care initiatives) and Veritas Insurance Corporation (a wholly-owned captive insurance company). While the University is a political subdivision of the state of Michigan, it is not a component unit of the State in accordance with the provisions of Governmental Accounting Standards Board ("GASB") Statement No. 14, *The Financial Reporting Entity*. The University is classified as a state instrumentality under Internal Revenue Code Section 115, and is also classified as a charitable organization under Internal Revenue Code Section 501(c)(3), and is therefore exempt from federal income taxes. Certain activities of the University may be subject to taxation as unrelated business income under Internal Revenue Code Sections 511 to 514.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, as prescribed by GASB and the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Audits of State and Local Governments*. The statements of net assets, revenues, expenses and changes in net assets and of cash flows are reported on a consolidated basis, and all intra-university transactions are eliminated as required by GASB.

The University reports as a special purpose government entity engaged primarily in business type activities, as defined by GASB, on the accrual basis. Business type activities are those that are financed in whole or in part by fees charged to external parties for goods or services. The University has the option of applying pronouncements issued by the Financial Accounting Standards Board ("FASB") after November 30, 1989, provided that such pronouncements do not conflict or contradict GASB pronouncements. The University has elected not to apply any FASB pronouncements issued after the applicable date.

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

Net assets are categorized as:

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

Restricted:

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

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

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

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

# Notes to Consolidated Financial Statements

## Note 1—Organization and Summary of Significant Accounting Policies, continued

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

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

Investments in nonmarketable limited partnerships are generally carried at fair value provided by the management of the investment partnerships as of March 31, 2012 and 2011, as adjusted by cash receipts, cash disbursements and securities distributions through June 30, 2012 and 2011, in order to provide an approximation of fair value at June 30. In addition, the carrying amount of these investments is adjusted for June 30 information from management of the investment partnerships when necessary to provide a reasonable estimate of fair value as of June 30, 2012 and 2011. Because these investments are not readily marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for the investments existed and such differences could be material.

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

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

Accounts receivable are recorded net of a provision for uncollectible accounts receivable. The provision is based on management's judgment of potential uncollectible amounts, which includes such factors as historical experience and type of receivable.

The University receives pledges and bequests of financial support from corporations, foundations and individuals. Revenue is recognized when a pledge representing an unconditional promise to pay is received and all eligibility requirements, including time requirements, have been met. In the absence of such a promise, revenue is recognized when the gift is received. Permanent endowment pledges do not meet eligibility requirements, as defined by GASB, and are not recorded as assets until the related gift is received.

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

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



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

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

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

For donor restricted endowments, the Uniform Prudent Management of Institutional Funds Act, as adopted in Michigan, permits the Board of Regents to appropriate amounts for endowment spending rule distributions as is considered prudent. The University's policy is to retain net realized and unrealized appreciation with the endowment after spending rule distributions. Net appreciation of permanent endowment funds, which totaled \$1,193,000,000 and \$1,312,000,000 at June 30, 2012 and 2011, respectively, is recorded in restricted expendable net assets. The University's endowment spending rule is further discussed in Note 2.

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

Patient care revenues are reported net of contractual allowances and bad debt expenses. Patient care services are primarily provided through the University of Michigan Health System, which includes the Hospitals and Health Centers, the Faculty Group Practice of the University of Michigan Medical School and the Michigan Health Corporation. Patient care services are also provided through University Health Services, which provides health care services to students, faculty and staff and Dental Faculty Associates, which provides dental care services performed by faculty dentists. Patient care services are provided to patients who meet certain criteria under the Hospitals and Health Centers' charity care policy without charge or at amounts less than its established rates. Accordingly, charity care is not reported as revenue in the accompanying statement of revenues, expenses and changes in net assets.

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

The University's policy for defining operating activities as reported on the statement of revenues, expenses and changes in net assets are those that generally result from exchange transactions such as payments received for providing services and payments made for services or goods received. Nearly all of the University's expenses are from exchange transactions. Certain significant revenue streams relied upon for operations are recorded as nonoperating revenues, as defined by GASB, including state appropriations, federal Pell grants, gifts and investment income.

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

# Notes to Consolidated Financial Statements

## Note 2—Cash and Investments

### NOTE 2—CASH AND INVESTMENTS

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

The UIP is invested together with the University's insurance and other short-term benefits reserves in the Daily and Monthly Portfolios, which are principally invested in investment-grade money market securities, U.S. government and other fixed income securities and absolute return strategies. Balances in the UIP are primarily for operating expenses and capital projects. The funding for capital projects remains in current operating investments until amounts for specific capital projects are transferred for capital activities.

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

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

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 fund shares to 4.5 percent. Distributions are being managed toward the new rate by keeping quarter to quarter distributions per share unchanged and moving toward the 4.5 percent rate when increases in the value of fund shares would otherwise result in higher per share distributions. 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. Distributions are also made from the UIP to University entities based on the 90-day U.S. Treasury Bill rate. The University's costs to administer and grow the University Endowment Fund and UIP are funded by investment returns.

**Cash and Cash Equivalents:** Cash and cash equivalents, which totaled \$238,690,000 and \$316,534,000 at June 30, 2012 and 2011, respectively, represent short-term money market investments in mutual funds, overnight collective funds managed by the University's custodian or short-term highly liquid investments registered as securities and held by the University or its agents in the University's name. Of its cash and cash equivalents, the University had actual cash balances in its bank accounts in excess of Federal Deposit Insurance Corporation ("FDIC") limits in the amount of \$92,000 and \$50,000 at June 30, 2012 and 2011, respectively. Under FDIC rules implemented during 2011, the University's noninterest-bearing transaction accounts have temporarily unlimited insurance coverage through December 31, 2012. The University does not require deposits to be collateralized or insured.

**Investments:** At June 30, 2012 and 2011, the University's investments, which are held by the University or its agents in the University's name, are summarized as follows:

(in thousands)	2012	2011
Cash equivalents, noncurrent	\$ 37,846	\$ 247,650
Fixed income securities	1,640,239	1,435,082
Commingled funds	1,630,173	1,571,478
Equity securities	783,792	1,002,151
Nonmarketable alternative investments	5,029,814	4,941,887
Other investments	8,818	8,248
	<u>\$ 9,130,682</u>	<u>\$ 9,206,496</u>

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

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

The University minimizes concentration of credit risk, the risk of a large loss attributed to the magnitude of the investment in a single issuer of fixed income securities, by diversifying its fixed income issues and issuers and holding U.S. Treasury securities which are considered to have minimal credit risk. The University also manages this risk at the account level by limiting each fixed income manager's holding of any non-U.S. government issuer to 5 percent of the value of the investment account.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of fixed income securities. Effective duration, a commonly used measure of interest rate risk, incorporates a security's yield, coupon, final maturity, call features and other imbedded options into one number expressed in years that indicates how price-sensitive a security or portfolio of securities is to changes in interest rates. The effective duration of a security or portfolio indicates the approximate percentage change in fair value expected for a one percent change in interest rates. The longer the duration, the more sensitive the security or portfolio is to changes in interest rates. The weighted average effective duration of the University's fixed income securities was 5.6 years at June 30, 2012, compared to 5.0 years at June 30, 2011. The University manages the effective duration of its fixed income securities at the account level, where fixed income managers generally may not deviate from the duration of their respective benchmarks by more than 25 percent.



# Notes to Consolidated Financial Statements

## Note 2—Cash and Investments, continued

The composition of fixed income securities at June 30, 2012 and 2011, along with credit quality and effective duration measures, is summarized as follows:

<b>2012</b>						
(in thousands)	U.S. Government	Non- Investment Grade	Investment Grade	Not Rated	Total	Duration (in years)
U.S. Treasury	\$ 251,671				\$ 251,671	4.7
U.S. Treasury inflation protected	351,700				351,700	4.6
U.S. government agency	218,340				218,340	0.6
Mortgage backed		\$ 27,593	\$ 19,322	\$ 1,999	48,914	0.4
Asset backed		31,680	2,091		33,771	2.3
Corporate and other		717,245	11,462	7,136	735,843	8.4
	\$ 821,711	\$ 776,518	\$ 32,875	\$ 9,135	\$ 1,640,239	5.6

<b>2011</b>						
(in thousands)	U.S. Government	Non- Investment Grade	Investment Grade	Not Rated	Total	Duration (in years)
U.S. Treasury	\$ 96,076				\$ 96,076	7.3
U.S. Treasury inflation protected	324,503				324,503	4.2
U.S. government agency	226,764				226,764	0.7
Mortgage backed		\$ 27,941	\$ 21,144		49,085	0.9
Asset backed		32,527	1,036		33,563	1.2
Corporate and other		677,307	17,525	\$ 10,259	705,091	7.0
	\$ 647,343	\$ 737,775	\$ 39,705	\$ 10,259	\$ 1,435,082	5.0

Of the University's fixed income securities, 97 percent were rated investment grade or better at June 30, 2012 and 2011, and 55 percent and 52 percent of these securities consisted of either U.S. treasury and government agencies or non-U.S. government securities rated AAA/Aaa at June 30, 2012 and 2011, respectively.

Commingled (pooled) funds include Securities and Exchange Commission regulated mutual funds and externally managed funds, limited partnerships and corporate structures which are generally unrated and unregulated. Certain commingled funds may use derivatives, short positions and leverage as part of their investment strategy. These investments are structured to limit the University's risk exposure to the amount of invested capital. The composition of commingled funds at June 30, 2012 and 2011 is summarized as follows:

(in thousands)	<b>2012</b>	<b>2011</b>
Absolute return	\$ 772,830	\$ 764,844
U.S. equities	225,631	101,890
Non-U.S./global equities	590,330	681,154
U.S. fixed income	33,714	15,123
Other	7,668	8,467
	\$ 1,630,173	\$ 1,571,478

Commingled funds have liquidity (redemption) provisions, which enable the University to make full or partial withdrawals with notice, subject to restrictions on the timing and amount. Of the University's commingled funds at June 30, 2012 and 2011, approximately 71 percent and 76 percent are redeemable within one year, with 48 and 51 percent redeemable within 90 days under normal market conditions. The remaining amounts are redeemable beyond one year, with redemption of certain funds dependent on disposition of the underlying assets.

Nonmarketable alternative investments consist of limited partnerships and similar vehicles involving an advance commitment of capital called by the general partner as needed and distributions of capital and return on invested capital as underlying strategies are concluded during the life of the partnership. There is no active secondary market for these alternative investments, which are generally unrated and unregulated, and the liquidity of these investments is dependent on actions taken by the general partner. The composition of these partnerships at June 30, 2012 and 2011 is summarized as follows:

(in thousands)	2012	2011
Private equity	\$ 1,295,654	\$ 1,326,341
Real estate	1,176,080	1,026,564
Absolute return	797,173	845,500
Energy	801,001	806,915
Venture capital	959,906	936,567
	<b>\$ 5,029,814</b>	<b>\$ 4,941,887</b>

The University's limited partnership investments are diversified in terms of manager selection and industry and geographic focus. At June 30, 2012 and 2011, no individual partnership investment represented 5 percent or more of total investments. The University's committed but unpaid obligation to these limited partnerships is further discussed in Note 13.

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

The University participates in non-U.S. developed and emerging markets through commingled funds invested in non-U.S./global equities and absolute return strategies. Although substantially all of these funds are reported in U.S. dollars, both price changes of the underlying securities in local markets and changes to the value of local currencies relative to the U.S. dollar are embedded in investment returns. In addition, a portion of the University's equity securities and nonmarketable alternative investments are denominated in foreign currencies, which must be settled in local (non-U.S.) currencies. Forward foreign currency contracts are typically used to manage the risk related to fluctuations in currency exchange rates between the time of purchase or sale and the actual settlement of foreign securities. Various investment managers acting for the University also use forward foreign exchange contracts in risk-based transactions to carry out their portfolio strategies.

Foreign exchange risk is the risk that investments denominated in foreign currencies may lose value due to adverse fluctuations in the value of the U.S. dollar relative to foreign currencies. The value of the University's non-U.S. dollar holdings net of outstanding forward foreign exchange contracts totaled \$993,456,000, or 11 percent of total investments at June 30, 2012, and \$1,224,168,000, or 13 percent of total investments at June 30, 2011. Non-U.S. dollar exposures are summarized as follows:

(in thousands)	2012	2011
Euros	\$ 554,088	\$ 642,096
British pounds sterling	152,504	175,837
Canadian dollar	79,117	104,274
Japanese yen	51,082	60,682
Other	156,665	241,279
	<b>\$ 993,456</b>	<b>\$ 1,224,168</b>

# Notes to Consolidated Financial Statements

## Note 2—Cash and Investments, continued

The University manages foreign exchange risk through the use of forward foreign currency contracts and manager agreements that provide minimum diversification and maximum exposure limits by country and currency.

The Daily and Monthly Portfolios held positions in bond futures at June 30, 2012 and 2011. Bond futures are used to adjust the duration of cash equivalents and the fixed income portion of the portfolios. To meet trading margin requirements, the University had U.S. government securities and cash with a fair value of \$2,389,000 and \$5,016,000 at June 30, 2012 and 2011, respectively, on deposit with its futures contract broker as collateral.

The Long Term Portfolio and the Monthly Portfolio participate in a short-term, fully collateralized, securities lending program administered by the University's master custodian. Together, the Portfolios had \$51,987,000 and \$103,622,000 in securities loans outstanding at June 30, 2012 and 2011, respectively. At loan inception, an approved borrower must deliver collateral of cash, securities or letters of credit to the University's lending agent equal to 102 percent of fair value for domestic securities and 105 percent for foreign securities. Collateral positions are monitored daily to insure that borrowed securities are never less than 100 percent collateralized. At June 30, 2012, collateral of \$54,300,000 (104 percent of securities on loan) includes invested cash of \$47,200,000 and University payables of \$7,100,000, while at June 30, 2011, collateral of \$107,900,000 (104 percent of securities on loan) includes invested cash of \$100,600,000, University payables of \$7,100,000 and U.S. government securities of \$200,000. Cash collateral held by the University's lending agent, along with the offsetting liability to return the collateral at loan termination, are recorded in the statement of net assets. Neither the University nor its securities lending agent has the ability to pledge or sell securities received as collateral unless a borrower defaults; accordingly, noncash collateral is not recorded in the statement of net assets. Securities loans may be terminated upon notice by either the University or the borrower.

### NOTE 3—ACCOUNTS RECEIVABLE

The composition of accounts receivable at June 30, 2012 and 2011 is summarized as follows:

(in thousands)	2012	2011
Patient care	\$ 529,079	\$ 430,378
Sponsored programs	84,303	80,997
State educational appropriations	55,924	65,796
Student accounts	23,482	22,858
Other	36,750	40,234
	729,538	640,263
Less provision for uncollectible accounts receivable	234,751	187,652
	<u>\$ 494,787</u>	<u>\$ 452,611</u>



**NOTE 4—NOTES AND PLEDGES RECEIVABLE**

The composition of notes and pledges receivable at June 30, 2012 and 2011 is summarized as follows:

(in thousands)	2012	2011
Notes:		
Federal student loan programs	\$ 87,628	\$ 89,271
University student loan funds	19,916	21,012
Other	537	542
	108,081	110,825
Less allowance for doubtfully collectible notes	3,100	3,100
Total notes receivable, net	104,981	107,725
Gift pledges outstanding:		
Capital	91,054	102,246
Operations	73,896	60,680
	164,950	162,926
Less:		
Allowance for doubtfully collectible pledges	11,303	9,643
Unamortized discount to present value	2,383	8,063
Total pledges receivable, net	151,264	145,220
Total notes and pledges receivable, net	256,245	252,945
Less current portion	59,553	58,586
	\$ 196,692	\$ 194,359

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

Payments on pledges receivable at June 30, 2012 are expected to be received in the following years ended June 30 (in thousands):

2013	\$ 48,717
2014	37,770
2015	33,956
2016	17,302
2017	10,088
2018 and after	17,117
	\$ 164,950

As discussed in Note 1, permanent endowment pledges do not meet eligibility requirements, as defined by GASB, until the related gift is received. Accordingly, permanent endowment pledges totaling approximately \$57,642,000 and \$59,374,000 at June 30, 2012 and 2011, respectively, are not recognized as assets in the accompanying financial statements. In addition, bequest intentions and other conditional promises are not recognized as assets until the specified conditions are met because of uncertainties with regard to their realizability and valuation.

# Notes to Consolidated Financial Statements

## Note 5—Capital Assets

### NOTE 5—CAPITAL ASSETS

Capital assets activity for the years ended June 30, 2012 and 2011 is summarized as follows:

2012				
(in thousands)	Beginning Balance	Additions	Retirements	Ending Balance
Land	\$ 94,365	\$ 378		\$ 94,743
Land improvements	106,849	5,065	\$ 108	111,806
Infrastructure	217,591	5,701		223,292
Buildings	6,021,971	850,314	97,040	6,775,245
Construction in progress	824,907	(598,091)		226,816
Property held for future use	53,823	(6,750)		47,073
Equipment	1,628,714	312,096	248,273	1,692,537
Library materials	473,414	22,288		495,702
	9,421,634	591,001	345,421	9,667,214
Less accumulated depreciation	4,228,461	443,132	342,043	4,329,550
	\$ 5,193,173	\$ 147,869	\$ 3,378	\$ 5,337,664

2011				
(in thousands)	Beginning Balance	Additions	Retirements	Ending Balance
Land	\$ 93,964	\$ 401		\$ 94,365
Land improvements	102,274	4,961	\$ 386	106,849
Infrastructure	213,772	3,819		217,591
Buildings	5,862,797	224,893	65,719	6,021,971
Construction in progress	545,595	279,312		824,907
Property held for future use	84,339	(30,516)		53,823
Equipment	1,623,287	128,267	122,840	1,628,714
Library materials	449,842	23,572		473,414
	8,975,870	634,709	188,945	9,421,634
Less accumulated depreciation	4,019,413	390,071	181,023	4,228,461
	\$ 4,956,457	\$ 244,638	\$ 7,922	\$ 5,193,173

The decrease in construction in progress of \$598,091,000 in 2012 represents the amount of capital expenditures for new projects of \$498,442,000 net of assets placed in service of \$1,096,533,000. The increase in construction in progress of \$279,312,000 in 2011 represents the amount of capital expenditures for new projects of \$562,924,000 net of capital assets placed in service of \$283,612,000. Interest of \$6,073,000 and \$17,599,000 was capitalized in 2012 and 2011, respectively.

Property held for future use represents the unoccupied portion of the North Campus Research Complex. The University acquired this property in June 2009 for \$114,029,000, including liabilities assumed in the purchase. During 2012 and 2011, \$6,750,000 and \$30,516,000, respectively, of the property was placed in service.

**NOTE 6—LONG-TERM DEBT**

Long-term debt at June 30, 2012 and 2011 is summarized as follows:

(in thousands)	2012	2011
Commercial Paper:		
Tax-exempt, variable rate (.15%)*	\$ 57,575	\$ 85,450
Taxable, variable rate (.16%)*	5,370	5,740
General Revenue Bonds:		
Series 2012A, variable rate (.14%)* through 2036	50,000	
Series 2012B, variable rate (.14%)* through 2042	65,000	
Series 2012C, 2.00% to 5.00% through 2017	89,605	
unamortized premium	13,802	
Series 2010A, taxable-Build America Bonds, 4.926% to 5.593% through 2040	163,110	163,110
Series 2010C, 2.00% to 5.00% through 2027	178,820	183,240
unamortized premium	14,363	15,997
Series 2010D, taxable-Build America Bonds, 1.051% to 5.333% through 2041	212,345	212,345
Series 2010E, 5.000% through 2012		7,200
unamortized premium		324
Series 2009A, 3.00% to 5.00% through 2029	86,680	91,020
Series 2009B, variable rate (.15%) through 2039	118,710	118,710
unamortized premium	6,724	7,189
Series 2009D, taxable-Build America Bonds, 5.155% to 6.172% through 2030	89,815	89,815
Series 2008A, variable rate (.15%)* through 2038	105,810	105,810
Series 2008B, variable rate (.13%)* to fixed via swap through 2026		
and variable rate 2027 through 2028	106,665	111,865
Series 2005A, 5.00% through 2018	17,560	22,060
unamortized premium	704	1,054
unamortized loss on extinguishment	(72)	(118)
Series 2002, variable rate (.16%)* to fixed via swap through 2018		
and variable rate 2019 through 2032	95,035	100,715
General Revenue Refunding Bonds:		
Series 2003, 3.50% to 5.00% through 2015	6,745	11,825
unamortized premium	118	310
unamortized loss on extinguishment	(18)	(51)
Hospital Revenue Bonds:		
Series 2007A, variable rate (.16%)* through 2038	26,195	26,195
Series 2007B, variable rate (.14%)* through 2038	44,310	44,310
Series 2005A, variable rate (.14%)* through 2036	69,315	69,315
Series 2005B, variable rate (.15%)* to fixed via swap through 2026	61,900	65,360
Hospital Revenue Refunding Bonds:		
Series 2002A, 5.00% to 5.25% through 2022	35,015	45,990
unamortized premium	213	405
unamortized loss on extinguishment	(1,251)	(1,482)
Series 1998A-2, variable rate (.14%)* to fixed via swap through 2025	44,670	44,670
Medical Service Plan Revenue Bonds:		
Series 1995A, variable rate (.16%)* through 2028	26,200	26,200
Series 1991, 7.05% capital appreciation through 2012		2,120
Medical Service Plan Revenue Refunding Bonds:		
Series 1998A-1, variable rate (.14%)* to fixed via swap through 2022	33,595	33,980
Housing Energy Conservation HUD Loan, 3.00% through 2021	1,636	1,792
	1,826,264	1,692,465
Less:		
Commercial paper and current portion of bonds payable	135,193	147,553
Long-term bonds payable subject to remarketing, net	482,202	274,895
	\$ 1,208,869	\$ 1,270,017

\*Denotes variable rate at June 30, 2012



# Notes to Consolidated Financial Statements

## Note 6—Long Term Debt, continued

The variable rate portions of bonds payable have remarketing features which allow bondholders to put debt back to the University. Accordingly, variable rate bonds payable are classified as current unless supported by long-term liquidity agreements, such as lines of credit or standby bond purchase agreements, which can refinance the debt on a long-term basis. The classification of the University's variable rate bonds payable at June 30, 2012 and 2011 is summarized as follows:

(in thousands)	2012	2011
Variable rate bonds payable subject to remarketing	\$ 847,405	\$ 747,130
Less:		
Current principal maturities	17,635	14,725
Long-term liquidity agreements:		
Unsecured lines of credit	150,000	150,000
Standby bond purchase agreements	197,568	307,510
Long-term bonds payable subject to remarketing, net	\$ 482,202	\$ 274,895

The University's available line of credit and standby bond purchase agreements which expire beyond one year, between July 2013 and July 2015, were entirely unused at June 30, 2012. In addition, the University has a \$106,000,000 standby bond purchase agreement which expires in March 2013 that was also entirely unused at June 30, 2012.

In connection with certain issues of variable rate debt, the University has entered into various floating-to-fixed interest rate swaps to convert all or a portion of the associated variable rate debt to synthetic fixed rates to protect against the potential of rising interest rates. The fair value, significant terms and other information about the University's interest rate swaps is discussed in Note 7.

Long-term debt activity, and the type of revenue it is supported by, for the year ended June 30, 2012 is summarized as follows:

(in thousands)	Beginning Balance	Additions	Reductions	Ending Balance
Commercial Paper:				
General revenues	\$ 91,190	\$ 107,530	\$ 135,775	\$ 62,945
Bonds and Notes:				
General revenues	1,242,420	219,200	40,099	1,421,521
Hospital revenues	294,763		14,396	280,367
Faculty Group Practice revenues	62,300	75	2,580	59,795
Student residences revenues	1,792		156	1,636
	\$ 1,692,465	\$ 326,805	\$ 193,006	\$ 1,826,264

The University maintains a combination of variable and fixed rate debt, with effective interest rates that averaged approximately 2.3 percent and 2.5 percent in 2012 and 2011, respectively, including the amortization of bond premiums and discounts and net of federal subsidies for interest on taxable Build America Bonds. The University utilizes commercial paper to provide interim financing for its capital improvement program. The Board of Regents has authorized the issuance of up to \$150,000,000 in commercial paper backed by a general revenue pledge. Outstanding commercial paper debt is converted to long-term debt financing, as appropriate, within the normal course of business.

During 2012, the University issued \$204,605,000 of General Revenue Bonds with a net original issue premium of \$14,595,000. Total bond proceeds of \$219,200,000 were utilized to convert \$119,310,000 of commercial paper to long-term debt and provide \$99,240,000 for capital projects and \$650,000 for debt issuance costs. General Revenue Bonds issued in 2012 include \$115,000,000 of variable rate bonds (Series 2012A and Series 2012B) and \$89,605,000 of fixed rate bonds (Series 2012C).

During 2011, the University issued \$219,545,000 of General Revenue Bonds with a net original issue premium of \$452,000. Total bond proceeds of \$219,997,000 were utilized to provide \$218,757,000 for capital projects and \$1,240,000 for debt issuance costs. General Revenue Bonds issued in 2011 include \$212,345,000 of fixed rate taxable Build America Bonds (Series 2010D) and \$7,200,000 of fixed rate tax-exempt bonds (Series 2010E).

Debt obligations are generally callable by the University and mature at various dates through fiscal 2042. Principal maturities and interest on debt obligations, based on scheduled bond maturities, for the next five years and in subsequent five-year periods are as follows:

(in thousands)	Principal	Interest*	Total
2013	\$ 130,526	\$ 43,006	\$ 173,532
2014	55,616	41,674	97,290
2015	56,696	40,423	97,119
2016	52,931	39,100	92,031
2017	117,491	37,729	155,220
2018-2022	264,881	151,429	416,310
2023-2027	313,110	111,855	424,965
2028-2032	306,075	64,655	370,730
2033-2037	322,010	36,718	358,728
2038-2042	172,345	9,769	182,114
	1,791,681	\$ 576,358	\$ 2,368,039
Plus unamortized premiums, net	34,583		
	<u>\$ 1,826,264</u>		

\*Interest on variable rate debt is estimated based on rates in effect at June 30, 2012; amounts do not reflect federal subsidies to be received for Build America Bonds interest

If all variable rate bonds were put back to the University and existing unsecured lines of credit and standby bond purchase agreements were not extended upon their current expiration dates, the total principal payments due in 2013 would increase to \$612,728,000, total principal payments due in 2014 would increase to \$298,154,000, total principal payments due in 2015 would increase to \$95,076,000 and total principal payments due in 2016 would increase to be \$61,901,000. Accordingly, principal payments due in subsequent years would be reduced to \$96,541,000 in 2017; \$162,521,000 in 2018 through 2022; \$170,300,000 in 2023 through 2027; \$130,305,000 in 2028 through 2032; \$89,805,000 in 2033 through 2037; and \$74,350,000 in 2038 through 2042. There would not be a significant impact on annual interest payments due to the low variable rate of interest on these bonds.

## NOTE 7—DERIVATIVE INSTRUMENTS

Derivatives held by the University are recorded at fair value in the statement of net assets in accordance with GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. For hedging derivative instruments that are effective in significantly reducing an identified financial risk, as defined by the Statement, the corresponding change in fair value is deferred and included in the statement of net assets. For all other derivative instruments, changes in fair value are reported as net investment income (loss).

# Notes to Consolidated Financial Statements

## Note 7—Derivative Instruments, continued

Derivative instruments held by the University at June 30, 2012 and 2011 are summarized as follows:

(in thousands)	2012		2011	
	Notional Amount	Fair Value	Notional Amount	Fair Value
Investment Derivative Instruments:				
Investment portfolios:				
Futures	\$ 352,820	\$ 186	\$ 393,232	\$ 54
Foreign currency forwards	557,644	(4,844)	772,286	2,085
Other	87,019	314	81,045	(198)
	\$ 997,483	\$ (4,344)	\$ 1,246,563	\$ 1,941
Floating-to-fixed interest rate swap on debt	\$ 40,405	\$ (3,600)	\$ 46,085	\$ (2,468)
Effective Cash Flow Hedges:				
Floating-to-fixed interest rate swaps on debt	\$ 230,115	\$ (44,869)	\$ 239,160	\$ (28,612)

The University utilizes bond futures in its investment portfolios to adjust the duration of cash equivalents and fixed income securities, while foreign currency forward contracts are utilized to settle securities and transactions denominated in foreign (non-US dollar) currencies and manage foreign exchange risk. Other derivative instruments in the University's investment portfolios consist primarily of interest rate swaps, credit default swaps, total return swaps and forward security purchase or sale commitments and are used to carry out investment and portfolio strategies.

In connection with certain issues of variable rate debt, the University has entered into various floating-to-fixed interest rate swaps to convert all or a portion of the associated variable rate debt to synthetic fixed rates to protect against the potential of rising interest rates. The fair value represents the estimated amount that the University would pay to terminate the swap agreements at the statement of net assets date, taking into account current interest rates and creditworthiness of the underlying counterparty. The notional amount represents the underlying reference of the instrument and does not represent the amount of the University's settlement obligations.

In accordance with GASB Statement No. 53, an interest rate swap is considered an effective cash flow hedge if the swap payments received substantially offset the payments made on the associated debt and changes in fair value are deferred. An interest rate swap that is not considered an effective cash flow hedge, in accordance with the provisions of this Statement, is deemed to be an investment derivative instrument and changes in fair value are recorded as net investment income (loss).

At June 30, 2012 and 2011, the fair value of floating-to-fixed interest rate swaps associated with the University's variable rate debt is a liability of \$48,469,000 and \$31,080,000, respectively, and is included in the statement of net assets as part of noncurrent other liabilities. The majority of the University's interest rate swaps qualify as effective hedges as defined by GASB Statement No. 53. The corresponding deferred asset for the fair value of swaps deemed effective cash flow hedges totaled \$44,869,000 and \$28,612,000, at June 30, 2012 and 2011, respectively, and is included in the statement of net assets as part of noncurrent other assets.



The change in fair value of derivative instruments, which includes realized gains and losses on positions closed, for the years ended June 30, 2012 and 2011 is summarized as follows:

(in thousands)	2012	2011
Investment Derivative Instruments:		
Investment portfolios:		
Futures	\$ 18,998	\$ 12,026
Foreign currency forwards	(1,198)	3,378
Other	(1,679)	762
	<u>\$ 16,121</u>	<u>\$ 16,166</u>
Floating-to-fixed interest rate swap on debt	\$ (1,132)	\$ 798
Effective Cash Flow Hedges:		
Floating-to-fixed interest rate swaps on debt	\$ (16,257)	\$ 4,046

The University's interest rate swaps, along with their associated variable rate debt and significant terms, are summarized below.

The floating-to-fixed interest rate swap associated with the Series 2008B General Revenue Bonds has a notional amount of \$89,950,000 and \$95,150,000 at June 30, 2012 and 2011, respectively, covering a portion of the principal outstanding and the notional amount decreases as principal on the underlying bonds is repaid. Effective from April 1, 2008, the University makes payments based on a fixed rate of 3.105 percent and receives variable rate payments from the swap counterparty based on 68 percent of One-Month USD LIBOR, until the swap terminates in April 2026. The University has the option to terminate the swap upon five business day written notice and payment of the fair market compensation for the value of the swap. This swap is considered an effective hedge at June 30, 2012 and 2011 and has a fair value of (\$13,610,000) and (\$7,607,000), respectively.

The floating-to-fixed interest rate swap associated with the Series 2005B Hospital Revenue Bonds has a notional amount of \$61,900,000 and \$65,360,000 at June 30, 2012 and 2011, respectively, tied to the outstanding balance of the bonds. Effective from December 1, 2005, the University makes payments based on a fixed rate of 3.229 percent and receives variable rate payments from the swap counterparty based on 68 percent of the One-Month USD LIBOR, until the bonds mature in December 2025. The University has the option to terminate the swap upon five business day written notice and payment of the fair market compensation for the value of the swap. This swap is considered an effective hedge at June 30, 2012 and 2011 and has a fair value of (\$9,365,000) and (\$5,404,000), respectively.

The floating-to-fixed interest rate swap associated with the Series 2002 General Revenue Bonds has a notional amount of \$40,405,000 and \$46,085,000 at June 30, 2012 and 2011, respectively, covering a portion of the principal outstanding and the notional amount decreases as principal on the underlying bonds is repaid. Effective from June 1, 2007, the University makes payments based on a fixed rate of 3.5375 percent and receives variable rate payments from the swap counterparty based on 68 percent of One-Month USD LIBOR, through April 1, 2009, and 63 percent of the Five-Year USD LIBOR Swap Rate for the balance of the term, through April 2018. The University has the option to terminate the swap upon five business day written notice and payment of the fair market compensation for the value of the swap. This swap is not considered an effective hedge at June 30, 2012 and 2011 and has a fair value of (\$3,600,000) and (\$2,468,000), respectively.

The floating-to-fixed interest rate swap associated with the Series 1998A-2 Hospital Revenue Refunding Bonds has a notional amount of \$44,670,000 at June 30, 2012 and 2011 tied to the outstanding balance of the bonds. Effective from May 14, 1998, the University makes payments based on a fixed rate of 4.705 percent and receives variable rate payments from the swap counterparty based on the floating Securities Industry and Financial Markets Association (SIFMA) Municipal Index through the final maturity dates of the underlying bonds in December 2024. The

# Notes to Consolidated Financial Statements

## Note 7—Derivative Instruments, continued

counterparty has the option of terminating the swaps if for any 180-day period the average variable rate is more than 7.0 percent. This swap is considered an effective hedge at June 30, 2012 and 2011 and has a fair value of (\$15,416,000) and (\$10,218,000), respectively.

The floating-to-fixed interest rate swap associated with the Series 1998A-1 Medical Service Plan Revenue Refunding Bonds has a notional amount of \$33,595,000 and \$33,980,000 at June 30, 2012 and 2011, respectively, tied to the outstanding balance of the bonds. Effective from May 14, 1998, the University makes payments based on a fixed rate of 4.685 percent and receives variable rate payments based on the floating SIFMA Municipal Index through the final maturity dates of the underlying bonds in December 2021. The counterparty has the option of terminating the swaps if for any 180-day period the average variable rate is more than 7.0 percent. This swap is considered an effective hedge at June 30, 2012 and 2011 and has a fair value of (\$6,478,000) and (\$5,383,000), respectively.

Using rates in effect at June 30, 2012, the projected cash flows for the floating-to-fixed interest rate swaps deemed effective hedges in accordance with the provisions of GASB Statement No. 53, along with the debt service requirements of the associated variable rate debt, are summarized as follows:

(in thousands)	Variable Rate Bonds		Swap	Total
	Principal	Interest	Payments, Net	Payments
2013	\$ 11,680	\$ 334	\$ 7,890	\$ 19,904
2014	12,155	318	7,504	19,977
2015	12,665	300	7,091	20,056
2016	13,195	283	6,669	20,147
2017	13,760	264	6,201	20,225
2018-2022	72,710	1,026	23,892	97,628
2023-2026	102,120	341	5,543	108,004
	<u>\$ 238,285</u>	<u>\$ 2,866</u>	<u>\$ 64,790</u>	<u>\$ 305,941</u>

By using derivative financial instruments to hedge exposures to changes in interest rates, the University is exposed to termination risk and basis risk. There is termination risk with floating-to-fixed interest rate swaps because the University or swap counterparty may terminate a swap if the other party fails to perform under the terms of the contract or its credit rating falls below investment grade. Termination risk is the risk that the associated variable rate debt no longer carries a synthetic fixed rate and if at the time of termination a swap has a negative fair value, the University is liable to the counterparty for payment equal to the swap's fair value. The University is also exposed to basis risk because some of the variable payments paid to the University by the counterparties are based on a percentage of LIBOR. Basis risk is the risk that changes in the relationship between SIFMA and LIBOR may impact the synthetic fixed rate of the variable rate debt. The University is not exposed to credit risk because the swaps have negative fair values.

The University is required to post collateral for certain floating-to-fixed interest rate swaps if the fair value of the swap reaches a minimum threshold. Based on the University's current credit ratings, the thresholds are \$26,000,000 for the swap associated with the Series 1998A-2 Hospital Revenue Refunding Bonds, \$27,000,000 for the swap associated with the Series 2005B Hospital Revenue Bonds and \$7,000,000 for the swap associated with the Series 1998A-1 Medical Service Plan Revenue Refunding Bonds. There are no collateral requirements for the other two swaps. During 2012, the University was required to post collateral of up to \$1,200,000 for a significant part of the year for the interest rate swap associated with the Series 1998A-1 Medical Service Plan Revenue Refunding Bonds. During 2011, the University was required to post collateral of \$1,061,000 for less than 90 days for the interest rate swap associated with the Series 1998A-1 Medical Service Plan Revenue Refunding Bonds. At June 30, 2012, the University had \$1,200,000 of posted collateral outstanding.

## NOTE 8—SELF-INSURANCE

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

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

Changes in the total reported liability for insurance and benefits obligations for the years ended June 30, 2012 and 2011 are summarized as follows:

(in thousands)	2012	2011
Balance, beginning of year	\$ 165,876	\$ 155,272
Claims incurred and changes in estimates	464,826	427,272
Claim payments	(443,726)	(416,668)
Balance, end of year	186,976	165,876
Less current portion	84,155	72,539
	<u>\$ 102,821</u>	<u>\$ 93,337</u>

## NOTE 9—POSTEMPLOYMENT BENEFITS

The University provides retiree health and welfare benefits, primarily medical, prescription drug, dental and life insurance coverage, to eligible retirees and their eligible dependents. Substantially all of the approximately 36,000 full-time permanent University employees may become eligible for these benefits if they reach retirement age while working for the University. For employees retiring on or after January 1, 1987, contributions toward health and welfare benefits are shared between the University and the retiree and can vary based on date of hire, date of retirement, age and coverage elections.

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

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

The University's annual postemployment benefits expense is actuarially determined in accordance with the parameters of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. Projections of benefits are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided and announced future changes at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point.

The University implemented GASB Statement No. 45 in 2008 and elected to amortize its initial unfunded actuarial accrued liability over one year, the minimum period allowed by the Statement. The University also elected to amortize subsequent changes in actuarial assumptions, plan design and experience gains and losses over a ten year closed period. Therefore, the liability for net postemployment benefits obligations recorded in the statement of net assets will differ from the actuarial accrued liability by the unamortized portion of changes in actuarial assumptions, plan design and experience gains and losses. At June 30, 2012, the recorded liability for net postemployment benefits obligations and the actuarial accrued liability totaled \$1,671,564,000 and \$1,269,091,000, respectively.



# Notes to Consolidated Financial Statements

## Note 9—Postemployment Benefits, continued

Changes in the total reported liability for postemployment benefits obligations for the years ended June 30, 2012 and 2011 are summarized as follows:

2012			
(in thousands)	Retiree Health and Welfare	Long-term Disability	Total
Balance, beginning of year	\$ 1,498,395	\$ 138,257	\$ 1,636,652
Service cost	43,599	3,138	46,737
Amortization of assumption changes, plan changes, and net actuarial (gains) losses	(62,590)	222	(62,368)
Interest cost	91,102	10,895	101,997
Payments of current premiums and claims	(39,286)	(12,168)	(51,454)
Balance, end of year	1,531,220	140,344	1,671,564
Less current portion	42,402	13,729	56,131
	\$ 1,488,818	\$ 126,615	\$ 1,615,433

2011			
(in thousands)	Retiree Health and Welfare	Long-term Disability	Total
Balance, beginning of year	\$ 1,468,563	\$ 139,545	\$ 1,608,108
Service cost	40,808	2,791	43,599
Amortization of assumption changes, plan changes, and actuarial losses	(63,307)	(405)	(63,712)
Interest cost	89,289	10,997	100,286
Payments of current premiums and claims	(36,958)	(14,671)	(51,629)
Balance, end of year	1,498,395	138,257	1,636,652
Less current portion	41,142	12,496	53,638
	\$ 1,457,253	\$ 125,761	\$ 1,583,014

Since a portion of retiree medical services will be provided by the University's Health System, the liability for postemployment benefit obligations is net of the related margin and fixed costs of providing those services which totaled \$262,905,000 of actuarial accrued liability at June 30, 2012 and \$239,012,000 at June 30, 2011. In accordance with GASB Statement No. 45, the University's liability for postemployment benefit obligations at June 30, 2012 is not reduced by the anticipated Medicare Retiree Drug Subsidy for future periods of approximately \$176,000,000 on an actuarial accrued liability basis.

The annual required contribution represents a level of funding that an employer is projected to need in order to prefund its obligations for postemployment benefits over its employees' years of service and totals \$110,210,000 and \$102,158,000 at June 30, 2012 and 2011, respectively. The University has no obligation to make contributions in advance of when insurance premiums or claims are due for payment and currently pays for postemployment benefits on a pay-as-you-go basis. The University's obligations for postemployment benefits at June 30, 2012, 2011 and 2010 as a percentage of covered payroll of \$2,826,760,000, \$2,665,924,000 and \$2,551,273,000, was 59, 61 and 63 percent, respectively.

The University's liability for postemployment benefits obligations was calculated using the projected unit credit method. Significant actuarial methods and assumptions used in the valuation for years ended June 30, 2012 and 2011 are as follows:

<b>2012</b>		
	Retiree Health and Welfare	Long-term Disability
Discount Rate	6.08%	7.88%
Inflation Rate	3.0%	3.0%
Immediate/Ultimate Medical Trend Rate	6.0%-7.0%/5.0%	6.0%-7.0%/5.0%
Immediate/Ultimate Rx Trend Rate	7.0%/5.0%	7.0%/5.0%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2000 Generational	2005 SOA Life Waiver (Modified)

<b>2011</b>		
	Retiree Health and Welfare	Long-term Disability
Discount Rate	6.08%	7.88%
Inflation Rate	3.0%	3.0%
Immediate/Ultimate Medical Trend Rate	7.0%-7.5%/5.0%	7.0%/5.0%
Immediate/Ultimate Rx Trend Rate	7.0%/5.0%	7.0%/5.0%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2000 Generational	2005 SOA Life Waiver (Modified)

During fiscal 2011, the University announced changes to eligibility requirements for retiree health benefits and the related amount of the University's contributions. 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.

## NOTE 10—RETIREMENT PLAN

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

Eligible employees generally contribute 5 percent of their pay and the University generally contributes an amount equal to 10 percent of employees' pay to the plan. Effective January 1, 2010, the University contribution commences after an employee has completed one year of employment. Participants may elect to contribute additional amounts to the plans within specified limits that are not matched by University contributions. Contributions and covered payroll under the plan (excluding participants' additional contributions) for the three years ended June 30, 2012 are summarized as follows:

(in thousands)	<b>2012</b>	<b>2011</b>	<b>2010</b>
University contributions	\$ 226,517	\$ 214,905	\$ 215,905
Employee contributions	\$ 117,127	\$ 108,981	\$ 106,389
Payroll covered under plan	\$ 2,826,760	\$ 2,665,924	\$ 2,551,273
Total payroll	\$ 2,963,848	\$ 2,802,045	\$ 2,698,219

# Notes to Consolidated Financial Statements

## Note 11—Net Assets

### NOTE 11—NET ASSETS

The composition of net assets at June 30, 2012 and 2011 is summarized as follows:

(in thousands)	2012	2011
Invested in capital assets, net of related debt	\$ 3,597,540	\$ 3,574,878
Restricted:		
Nonexpendable:		
Permanent endowment corpus	1,345,859	1,279,058
Expendable:		
Net appreciation of permanent endowments	1,193,281	1,312,282
Funds functioning as endowment	1,597,480	1,652,381
Restricted for operations and other	492,878	502,569
Unrestricted	2,526,159	2,603,094
	<u>\$ 10,753,197</u>	<u>\$ 10,924,262</u>

Unrestricted net assets, as defined by GASB, are not subject to externally imposed stipulations; however, they are subject to internal restrictions. For example, unrestricted net assets may be designated for specific purposes by action of management or the Board of Regents. All of the unrestricted net assets, which totaled \$2,526,159,000 and \$2,603,094,000 at June 30, 2012 and 2011, respectively, have been designated for academic and research programs and initiatives and capital programs.

### NOTE 12—FEDERAL DIRECT LENDING PROGRAM

The University distributed \$372,703,000 and \$358,981,000 for the years ending June 30, 2012 and 2011, respectively, for student loans through the U.S. Department of Education ("DoED") federal direct lending program. These distributions and related funding sources are not included as expenses and revenues in the accompanying financial statements. The statement of net assets includes a receivable of \$1,364,000 and \$624,000 at June 30, 2012 and 2011, respectively, for DoED funding received subsequent to distribution.

### NOTE 13—COMMITMENTS AND CONTINGENCIES

Authorized expenditures for construction and other projects unexpended as of June 30, 2012 were \$780,104,000. Of these expenditures, approximately \$728,547,000 will be funded by internal sources, gifts, grants and future borrowings and the remaining \$51,557,000 will be funded using unexpended debt proceeds.

Under the terms of various limited partnership agreements approved by the Board of Regents or by University officers, the University is obligated to make periodic payments for advance commitments to venture capital, private equity, real estate, energy and absolute return strategies. As of June 30, 2012, the University had committed, but not paid, a total of \$2,003,690,000 in funding for these alternative investments. Based on historical capital calls and discussions with those managing the limited partnerships, outstanding commitments for such investments are anticipated to be paid in the following years ended June 30 (in thousands):

2013	\$ 393,449
2014	472,216
2015	421,277
2016	301,679
2017	214,422
2018 and beyond	200,647
	<u>\$ 2,003,690</u>



These commitments are generally able to be called prior to an agreed commitment expiration date and therefore may occur earlier or later than estimated.

The University has entered into operating leases for space, which expire at various dates through 2027. Outstanding commitments for these leases are expected to be paid in the following years ended June 30 (in thousands):

2013	\$ 31,363
2014	23,293
2015	18,629
2016	9,890
2017	5,893
2018-2022	11,108
2023-2027	2,129
	<hr/>
	\$ 102,305

Operating lease expenses totaled \$32,856,000 and \$33,529,000 in 2012 and 2011, respectively.

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

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

#### NOTE 14—SEGMENT INFORMATION

A segment is an identifiable activity reported as a stand-alone entity for which one or more revenue bonds are outstanding. A segment has a specific identifiable revenue stream pledged in support of revenue bonds and has related expenses, gains and losses, assets and liabilities that are required by an external party to be accounted for separately. The University has one segment that meets the reporting requirements of GASB.

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

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

# Notes to Consolidated Financial Statements

## Note 14—Segment Information, continued

Condensed financial information for HHC, before the elimination of certain intra-University transactions, as of and for the years ended June 30, 2012 and 2011 is as follows:

(in thousands)	2012	2011
<b>Condensed Statement of Net Assets</b>		
Assets:		
Current assets	\$ 321,394	\$ 357,509
Noncurrent assets	2,812,436	2,793,939
Total assets	\$ 3,133,830	\$ 3,151,448
Liabilities:		
Current liabilities	\$ 284,049	\$ 292,503
Noncurrent liabilities	1,214,345	1,108,267
Total liabilities	1,498,394	1,400,770
Net assets:		
Invested in capital assets, net of related debt	675,615	702,096
Restricted:		
Nonexpendable	3,386	2,899
Expendable	100,521	100,672
Unrestricted	855,914	945,011
Total net assets	1,635,436	1,750,678
Total liabilities and net assets	\$ 3,133,830	\$ 3,151,448
<b>Condensed Statement of Revenues, Expenses and Changes in Net Assets</b>		
Operating revenues	\$ 2,139,229	\$ 1,990,214
Operating expenses other than depreciation expense	(1,963,732)	(1,793,016)
Depreciation expense	(186,631)	(144,238)
Operating (loss) income	(11,134)	52,960
Nonoperating revenues, net	1,246	198,307
Net (loss) income before transfers	(9,888)	251,267
Transfers to other University units, net	(105,354)	(102,405)
(Decrease) increase in net assets	(115,242)	148,862
Net assets, beginning of year	1,750,678	1,601,816
Net assets, end of year	\$ 1,635,436	\$ 1,750,678
<b>Condensed Statement of Cash Flows</b>		
Net cash provided by operating activities	\$ 140,047	\$ 201,706
Net cash provided by investing activities	73,484	31,529
Net cash used in capital and related financing activities	(189,802)	(168,976)
Net cash used in noncapital financing activities	(100,180)	(99,263)
Net decrease in cash and cash equivalents	(76,451)	(35,004)
Cash and cash equivalents, beginning of year	120,811	155,815
Cash and cash equivalents, end of year	\$ 44,360	\$ 120,811

**NOTE 15—OPERATING EXPENSES BY FUNCTION**

Operating expenses by functional classification for the years ended June 30, 2012 and 2011 are summarized as follows:

2012					
(in thousands)	Compensation and Benefits	Supplies and Services	Depreciation	Scholarships and Fellowships	Total
Instruction	\$ 771,636	\$ 120,816			\$ 892,452
Research	488,738	230,004			718,742
Public service	87,945	41,659			129,604
Academic support	191,354	40,975			232,329
Student services	68,837	20,120			88,957
Institutional support	133,302	49,941			183,243
Operations and maintenance of plant	40,269	244,300			284,569
Auxiliary enterprises	2,022,144	725,850			2,747,994
Depreciation			\$ 443,132		443,132
Scholarships and fellowships				\$ 121,040	121,040
	\$ 3,804,225	\$ 1,473,665	\$ 443,132	\$ 121,040	\$ 5,842,062

2011					
(in thousands)	Compensation and Benefits	Supplies and Services	Depreciation	Scholarships and Fellowships	Total
Instruction	\$ 746,347	\$ 106,790			\$ 853,137
Research	486,677	246,847			733,524
Public service	86,891	44,597			131,488
Academic support	183,866	37,150			221,016
Student services	66,669	18,478			85,147
Institutional support	130,979	49,194			180,173
Operations and maintenance of plant	39,142	236,149			275,291
Auxiliary enterprises	1,893,194	560,446			2,453,640
Depreciation			\$ 390,071		390,071
Scholarships and fellowships				\$ 114,316	114,316
	\$ 3,633,765	\$ 1,299,651	\$ 390,071	\$ 114,316	\$ 5,437,803



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