FINANCIAL REPORT
2001-2002

MICHIGAN STATE
UNIVERSITY

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FINANCIAL REPORT

2001-2002

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This report presents the financial position and results of operations of Michigan State University for the fiscal years ended June 30, 2002 and June 30, 2001. The financial report has been adopted by the Board of Trustees and is provided as part of the commitment by Michigan State University to report annually on its fiscal affairs. These financial statements and notes on pages 10 through 22 have been audited by KPMG LLP, Certified Public Accountants. Their audit report appears on page 9.

As readers will note, the University implemented new financial reporting standards for the fiscal year ended June 30, 2002, as required by the Governmental Accounting Standards Board and applied those standards on a retroactive basis to the comparative amounts shown for the fiscal year ended June 30, 2001. Previous financial statements focused on the accountability of funds, while these statements focus on the financial condition of the University, the results of operations, and cash flows of the University as a whole.

Michigan State University's outstanding academic programs, research opportunities and outreach experiences continue to attract excellent students. Following one of the strongest recruiting efforts in recent years, MSU welcomed a fall 2001 freshman class with an average high school GPA of 3.55 and an average ACT score of 24.2. MSU's ability to provide a quality education at an affordable cost was recognized in September 2001 by *U.S. News and World Report*, which rated MSU among the nation's top 50 "great schools at great prices." With more than 44,000 students enrolled in 200 programs of undergraduate and graduate studies, its 14 degree-granting colleges and affiliated private law school attract scholars from around the world who are interested in combining education with practical problem solving.

The University continued its efforts to develop a more diverse source of revenues to support its missions of teaching, research and public service. For the first time in its history, MSU is ranked in the top 20 nationally and 10th among public research doctoral universities in the amount of private contributions raised. These rankings are released by RAND Corporation's Council for Aid to Education (CAE) and are based on CAE's annual Voluntary Support of Education survey of the 2000-01 fiscal year. For comparison, MSU was ranked 42nd in 1992. In the past two years, MSU has risen from ninth to sixth in the Big Ten in the amount of private gifts raised.

Efforts continued to modernize and renew campus facilities through a series of renovation projects, including the $9.7 million Shaw Hall renovation project, which required the Hall to be closed for the 2001-02 academic year. Changes in the campus landscape this year included the opening in April 2002 of the $93 million Biomedical and Physical Sciences Building, which is now MSU's largest academic building with 200,000 net square feet of space. A less obvious, but nonetheless significant project was the replacement of artificial turf with natural turf in Spartan Stadium in June 2002–the culmination of an 18-month project made possible by MSU's turfgrass technology.

MSU joined with the nation in shock and sorrow following the events of September 11, 2001. MSU also reached out in practical ways, such as establishing the September 11 Scholarship Program to benefit 11 youngsters whose parents were killed in the terrorist attacks. In his annual State of the University address, President Peter McPherson challenged all public universities to heed the wake-up call of September 11 and to make long-term commitments to solving global problems that universities are uniquely qualified to address.

For nearly 150 years, since its founding in 1855, MSU has been advancing knowledge and transforming lives through innovative research, teaching, and outreach. With more than 300,000 alumni worldwide, it is recognized as a major public university with global reach and extraordinary impact. President McPherson's challenge continues to be woven into the fabric of MSU as it persists–through its people, programs and facilities–to impact the state, the nation and the world through high-impact and innovative initiatives.

Fred L. Poston
Vice President for Finance and Operations and Treasurer

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Introduction

The following discussion and analysis provides an overview of the financial position and activities of Michigan State University (the "University" or "MSU") for the year ended June 30, 2002, with selected comparative information for the year ended June 30, 2001. This discussion has been prepared by management along with the financial statements and related footnote disclosures and should be read in conjunction with and is qualified in its entirety by the financial statements and footnotes. While the University is a political subdivision of the State of Michigan with an elected Board of Trustees, it is not a component unit of the State as defined by the Governmental Accounting Standards Board (GASB).

Financial Highlights

The University's financial position remained solid as of June 30, 2002, despite the challenges posed by a weakened economy, a declining stock market, state appropriation increases that were lower than the rate of inflation, double digit health care cost increases and facility renovation and maintenance requirements. Ongoing internal budget reductions and reallocations focused resources in strategic and opportunistic mission priorities.

Select highlights include:

- Net assets increased $54 million to $1.6 billion due primarily to planned additions to reserves for various infrastructure projects.
- Revenues totaled $1.3 billion.
- Research expenditures increased 8.6% to $201 million.
- Completed construction of the $93 million Biomedical and Physical Sciences Building.
- Swapped approximately $100 million of variable rate debt to a 4.074% fixed rate.
- Earned 2.3% total return on endowment portfolio in declining market environment.

Using the Annual Report

The University's annual report consists of three basic financial statements: the Statement of Net Assets; the Statement of Revenues, Expenses and Changes in Net Assets; and the Statement of Cash Flows. These financial statements are prepared in accordance with GASB principals. Effective with the fiscal year ended June 30, 2002, the University adopted GASB Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, and Statement No. 35, *Basic Financial Statements-and Management's Discussion and Analysis-for Public Colleges and Universities,* as amended by GASB Statements No. 37 and No. 38, and applied those standards on a retroactive basis. These statements establish standards for external reporting for public colleges and universities and require that financial statements be presented on a consolidated basis to focus on the university as a whole, with resources classified for accounting and reporting purposes into four net asset categories. Previous financial statements focused on the accountability of individual fund groups rather than the university as a whole.

Other significant changes to the financial statements are as follows:

- Revenues and expenses are now categorized as either operating or nonoperating. Significant recurring sources of the University's revenue, including state appropriations, gifts and investment income (loss) are defined as nonoperating by GASB. To the extent a university utilizes nonoperating revenues to meet their operating expenses, an operating loss will occur on the Statement of Revenues, Expenses and Changes in Net Assets.

- Unexpended cash advances received from sponsored programs are now recorded as deferred revenue where the University has not met the requirements to earn such revenue. Previously, amounts received were recognized as revenue upon receipt.

- Scholarship and fellowship awards over which the University exercises control are now shown as a reduction of student tuition and fee revenues, while stipends and other payments made directly to students continue to be presented as scholarship and fellowship expenses. Previously, all scholarships and fellowships were presented as expenses.

Statement of Net Assets

The Statement of Net Assets includes all assets and liabilities. It is prepared under the accrual basis of accounting, whereby revenues and assets are recognized when the service is provided and expenses and liabilities are recognized when others provide the service, regardless of when cash is exchanged. Assets and liabilities are generally measured using current values. One exception is capital assets, which are stated at historical cost less an allowance for depreciation.

A summarized comparison of the University's assets, liabilities and net assets at June 30, 2002 and 2001 follows:

	2002	**2001**
	(in millions)	
Current assets	$ 375	$ 417
Noncurrent assets:		
Endowment and other investments	760	663
Capital assets - net	927	870
Other	52	60
Total assets	2,114	2,010
Current liabilities	198	172
Noncurrent liabilities	275	251
Total liabilities	473	423
Total net assets	$ 1,641	$ 1,587

Over time, increases or decreases in net assets are one indicator of the improvement or erosion of the University's financial health when considered with non-financial facts such as enrollment levels, strength of faculty and condition of the facilities. A review of the University's Statement of Net Assets at June 30, 2002 and 2001 indicates that the University protected its financial position in anticipation of continued financial challenges. This has been achieved by focusing on cost controls, pursuing a long-term investment strategy to maximize risk-adjusted total returns, and appropriate utilization of debt and other resources to meet programmatic needs, including the maintenance and replacement of the University's infrastructure.

Current assets:

Current assets consist of operating cash and investments, net accounts and interest receivable and other assets totaling $375 million and $417 million at June 30, 2002 and 2001, respectively. The net $42 million decrease from the prior year primarily represents the reallocation of certain operating cash and investments to endowment investments, consistent with the University's cash management and investment plan.

Current liabilities:

Current liabilities consist primarily of trade accounts payable, accrued compensation and other personnel costs, deferred revenues and other liabilities payable within one year or less. Current liabilities totaled $198 million at June 30, 2002, compared to $172 million at June 30, 2001. As noted previously, a change in accounting treatment for unexpended cash advances received from sponsored programs now requires the recording of such amounts as deferred revenue. Accordingly, the net increase in current liabilities is primarily due to deferred revenues in sponsored programs, which increased $14 million.

Noncurrent assets:

Endowment and other investments

As of June 30, 2002, the University's endowment investments totaled $511 million, an increase of $90 million from the prior year. During the year, $60 million of operating cash and investments was reallocated to establish certain term endowments consistent with the revised investment strategy adopted by the University's Board of Trustees in July 2000. Gifts to permanent endowments of $24 million and changes in the market value of the investments from the prior year accounted for the majority of the remaining increase.

Other investments totaled $249 million, an increase of $7 million from the prior year and consisted primarily of the Operating Cash Pool's total return-oriented bond portfolio which totaled $170 million at June 30, 2002. Funded retirement and post-employment benefit reserves substantially account for the remainder.

Capital assets, net

The University continues to implement its long-range plan to modernize and renew its teaching, research and residential life facilities in support of its missions. At June 30, 2002 and 2001, the University's net investment in capital assets is as follows:

	2002	2001
	(in millions)	
Land	$ 19	$ 18
Buildings and site improvements	1,257	1,090
Construction in progress	47	123
Equipment and other	396	386
Capital assets not depreciated	4	4
Less: accumulated depreciation	(796)	(751)
	$ 927	$ 870

Major capital additions during the year included the $24 million James B. Henry Executive Development Center and the remaining $12 million related to completion of the $93 million Biomedical and Physical Sciences Building.

As of June 30, 2002, the University had initiated plans and incurred certain contractual commitments related to the construction and renovation of various facilities. The costs to complete the projects are estimated to be $42 million and are to be funded from the State of Michigan and the State Building Authority (SBA) appropriations, private gifts, debt proceeds or other University funds.

Noncurrent liabilities, primarily debt:

As of June 30, 2002, the University had total debt obligations outstanding of $260 million compared with $238 million at June 30, 2001. This balance is composed primarily of outstanding General Revenue Bonds of $203 million at June 30, 2002 and $206 million at June 30, 2001. The University reviews its debt capacity and related capital assets needs to optimize the use of long-term resources. MSU's outstanding bonds carry an investment grade bond rating from Moody's of Aa2.

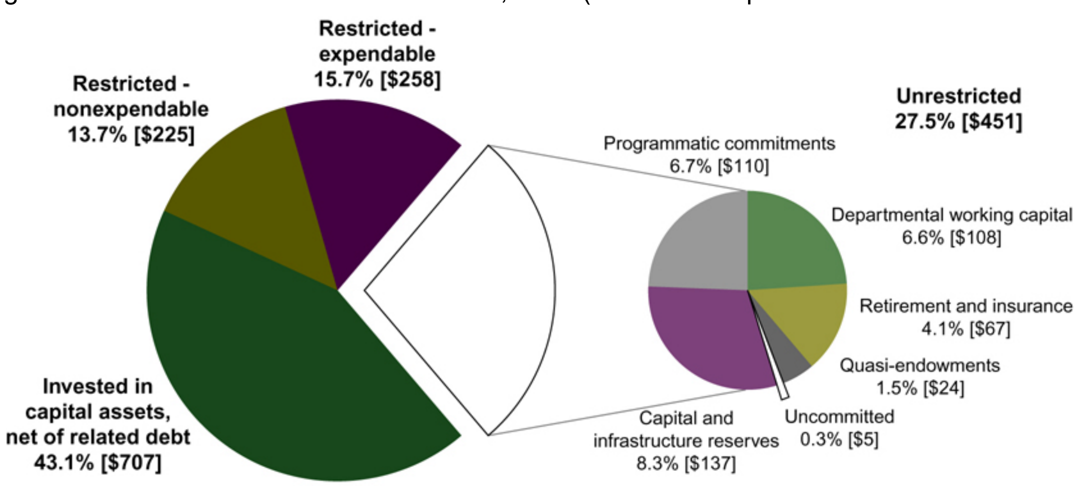
In August 2002, the University issued $65 million of General Revenue Bonds to finance the purchase of the James B. Henry Executive Development Center and the construction and renovation of various other high-priority capital improvements.

Net assets:

Net assets represent residual University assets after liabilities are deducted. The University's net assets at June 30, 2002 and 2001 are summarized as follows:

	2002	2001
	(in millions)	
Invested in capital assets, net of related debt	$ 707	$ 707
Restricted:		
Nonexpendable	225	211
Expendable	258	254
Total restricted	483	465
Unrestricted	451	415
Total net assets	$ 1,641	$ 1,587

The following is a breakdown of Net assets at June 30, 2002 (amounts are presented in millions of dollars):



TOTAL NET ASSETS $1.6 BILLION

Net assets invested in capital assets, net of related debt, represent the University's land, buildings and equipment net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

Restricted nonexpendable net assets are made up of the University's permanent endowment funds.

Restricted expendable net assets, which are subject to externally imposed restrictions governing their use, include restricted quasi-endowments, restricted gifts and federal and state sponsored programs.

Although unrestricted net assets are not subject to externally imposed restrictions, virtually all of the University's unrestricted net assets are designated for purposes to fulfill its various fiduciary responsibilities including maintaining reserves for capital projects, accrued post-employment benefits, working capital for self-supporting departmental activities, and unrestricted quasi-endowments. At June 30, 2002, total uncommitted, unrestricted net assets approximated $4.7 million or .3% of total net assets.

The University's ongoing review of its infrastructure indicates a need to expend approximately $500 million over the next 10 years to modernize and renovate aging teaching, research, housing and other support facilities, utility systems and roads, consistent with its just-in-time maintenance strategy. The University intends to address these maintenance and technology needs through the use of capital and infrastructure reserves, appropriate use of additional borrowing and efforts to obtain additional gifts, grants and capital appropriations.

In addition, the University faces the challenge of funding its health care and dental benefits costs, which have been increasing at double-digit rates. This includes the cost of providing post employment health and dental benefits to eligible employees. Under current government accounting standards, the University is not allowed to record this liability, which was estimated at $500 million as of June 2000, the latest actuarial calculation.

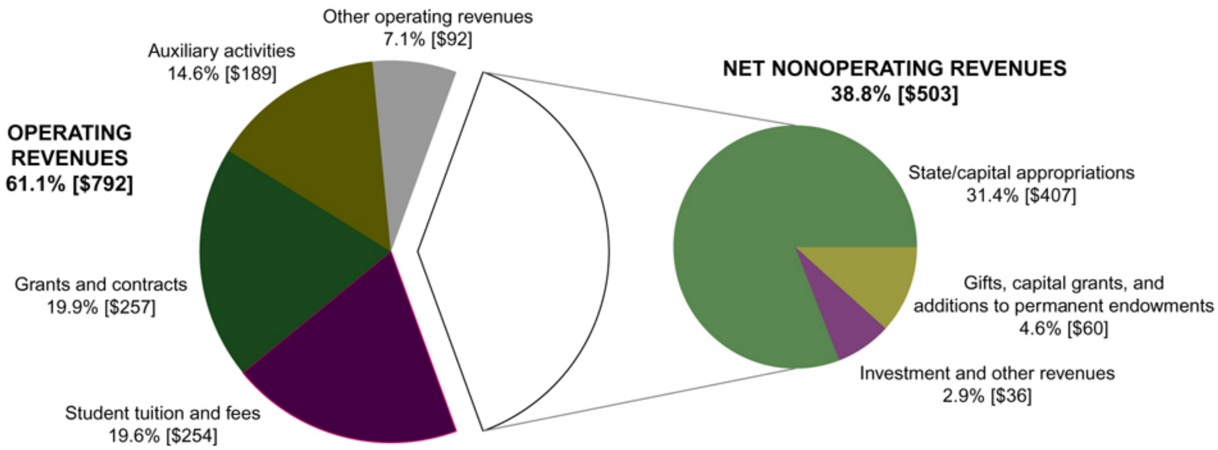
Statement of Revenues, Expenses and Changes in Net Assets

The Statement of Revenues, Expenses and Changes in Net Assets presents the operating results of the University, as well as the nonoperating revenues and expenses. Operating revenues primarily include net student tuition and fees, grants and contracts, and auxiliary activities. Given a public university's dependency on revenues such as state appropriations, gifts and investment income, which are prescribed by GASB as nonoperating revenues, operating expenses will typically exceed operating revenues resulting in an operating loss. Net nonoperating revenues or expenses are an integral component in determining the increase or decrease in net assets.

A summarized comparison of the University's revenues, expenses and changes in net assets for the years ended June 30, 2002 and 2001 follows:

	2002	2001
	(in millions)	
Operating revenues:		
Student tuition and fees, net of allowances	$ 254	$ 232
Grants and contracts	257	228
Auxiliary activities	189	168
Other operating revenues	92	97
Total operating revenues	792	725
Operating expenses:		
Instruction and departmental research	397	374
Research	201	185
Public services	156	137
Academic support	60	54
Student services	24	23
Scholarships and fellowships	24	22
Institutional support	56	54
Operation and maintenance of plant	83	77
Auxiliary enterprises	169	151
Depreciation	61	57
Other expenses	10	6
Total operating expense	1,241	1,140
Operating income (loss)	(449)	(415)
Nonoperating revenues (expenses):		
State appropriations	395	389
Gifts	30	40
Net investment income (loss)	42	60
Interest expense on capital asset related debt	(7)	(6)
Other revenues (expenses)	1	(1)
State capital appropriations	12	48
Capital grants and gifts	6	13
Additions to permanent endowments	24	17
Net nonoperating revenues (expenses)	503	560
Increase (decrease) in net assets	54	145
Net assets beginning of year	1,587	1,442
Net assets end of year	$ 1,641	$ 1,587

The following is a graphic illustration of total revenue by source for the year ended June 30, 2002 (amounts are presented in millions of dollars):

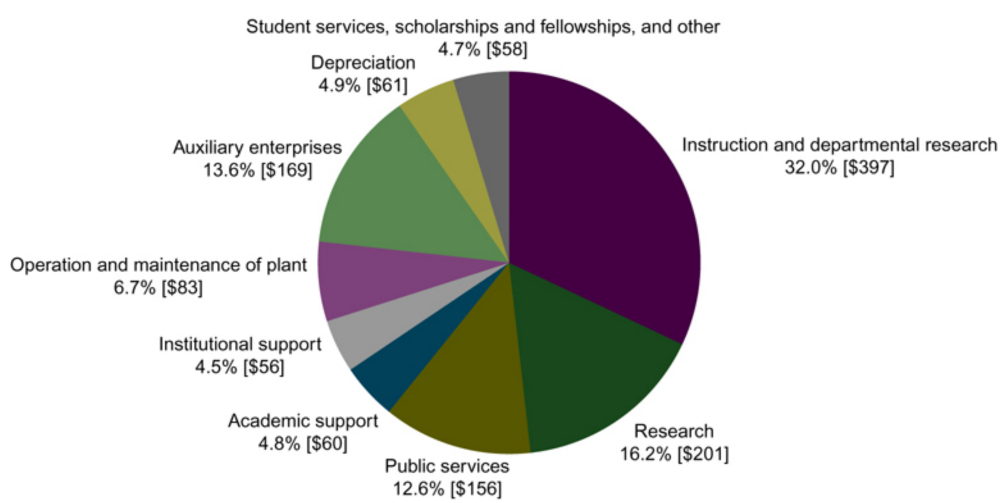


TOTAL REVENUE $1.3 BILLION

The University is supported by a diverse stream of revenue which supplements its student tuition and fees, including state appropriations, federal and state sponsored programs, private gifts and grants and investment income. The University continues to seek funding from all possible sources consistent with its mission and to manage the financial resources realized from these efforts to fund its operations.

Operating revenues for fiscal year 2002 totaled $792 million compared with $725 million for fiscal year 2001, an increase of $67 million. The most significant source of operating revenue for the University was tuition and fees (net of scholarship allowances) totaling $254 million. The 10.0% increase in tuition and fees revenue reflects an 8.9% rate increase in tuition and fees and a 1.1% revenue increase from additional student credit hours taken. Other major revenue sources include auxiliary services of $189 million and federal grants and contracts of $183 million.

The following is a graphic illustration of operating expenses by source for the year ended June 30, 2002 (amounts are presented in millions of dollars):



TOTAL OPERATING EXPENSES $1.2 BILLION

Operating expenses, including depreciation of $61 million, totaled $1.2 billion compared to $1.1 billion for the year ended June 30, 2001. Of this total, $754 million (60.8%) was used for instruction and departmental research, research and public service, which are the core missions of the University, compared with $696 million (61.1%) in the prior year.

Net nonoperating revenues totaled $503 million for the year ended June 30, 2002, a decrease of $57 million from the prior year. The primary source of this revenue is state appropriations, which totaled $395 million, a planned increase of $6 million (1.5%) from the prior year. Decreases in gift revenue ($10 million), net investment income ($18 million) and state capital appropriations ($36 million) primarily accounted for the decline in net nonoperating revenues in 2002.

Economic Factors

As a result of economic pressures affecting the State, 2002-03 state appropriations were maintained at 2001-02 levels and the Board of Trustees approved an 8.9% increase for fall 2002 in-state tuition and required fees. The University's economic future is tied to that of the State, as there is a direct relationship between the growth of state appropriations and the increase in tuition and fee levels. Declines or no changes in state appropriations generally result in increased tuition and fee levels. Continued economic pressures affecting the State will most likely result in smaller increases in state appropriations for higher education. The specific impact on the University is uncertain.

A major strength of the University remains its committed faculty and staff. Continued progress needs to be made to attract and retain high-quality talent. Escalating health care costs, which are expected to increase approximately 15-20% in 2002-03, also need to be controlled. In addition, the University faces the challenge of funding its post-employment health care and dental benefits. As noted earlier, under current government accounting standards, the University is not allowed to record this liability, which was estimated at $500 million as of June 2000.

The University's long-range plan is to update and renovate aging teaching, research, housing and support facilities by addressing an estimated $500 million of infrastructure needs over the next 10 years. Through the appropriate use of existing reserves, additional borrowing and efforts to obtain additional gifts, grants and capital appropriations, the University plans to address capital improvement and technology issues to advance teaching and research methodologies throughout the University.

The University continues to pursue its long-term investment strategy to maximize total returns, at an appropriate level of risk, while utilizing a spending rate policy to insulate the University's operations from market volatility.

For the seventh straight year, MSU has completed a record-setting year in fund raising, laying a foundation for the upcoming public phase of the University's capital campaign, The Campaign for MSU, set to launch in September 2002. This success over the last several years positions MSU favorably for the public phase, which will run from 2002 to 2007.

In summary, to meet the challenges outlined above the University focused on cost containment and revenue initiatives to maintain and support academic programs, while bridging the State's current economic cycle.

KPMG

Suite 1200
150 West Jefferson
Detroit, MI 48226-4429

Independent Auditors' Report

To the Board of Trustees
Michigan State University:

We have audited the accompanying basic financial statements of Michigan State University (the University) as of and for the years ended June 30, 2002 and 2001, as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express our opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Michigan State University as of June 30, 2002 and 2001, and its changes in financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we have also issued a report dated August 30, 2002 on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the result of our audit.

As described in note 1, during the year ended June 30, 2002, the University adopted the provisions of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments;* GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities – An Amendment of GASB Statement No. 34;* GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus;* and GASB Statement No. 38, *Certain Financial Statement Note Disclosures.*

The Management's Discussion and Analysis on pages 1 through 8 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

August 30, 2002

STATEMENT OF NET ASSETS
Michigan State University

	June 30, 2002	June 30, 2001
ASSETS		
Current assets:		
Operating cash and investments (Note 2)	$ 211,033,173	$ 249,286,085
Accounts and interest receivable, net (Note 3)	124,402,795	131,255,290
Student loans receivable, net (Note 4)	8,267,483	7,685,917
Pledges receivable, net (Note 5)	13,216,187	10,262,648
Inventories and other assets	18,223,155	18,625,554
Total current assets	375,142,793	417,115,494
Noncurrent assets:		
Endowment investments (Note 2)	511,434,742	420,869,970
Other investments (Note 2)	248,709,742	242,107,715
Student loans receivable, net (Note 4)	27,535,664	29,776,587
Pledges receivable, net (Note 5)	15,884,275	22,181,826
Investments in joint ventures (Note 12)	6,944,220	6,362,996
Unamortized bond origination costs	1,861,997	1,884,495
Capital assets, net (Note 13)	926,756,621	869,921,760
Total noncurrent assets	1,739,127,261	1,593,105,349
Total assets	$ 2,114,270,054	$ 2,010,220,843
LIABILITIES		
Current liabilities:		
Accounts and interest payable	$ 30,057,627	$ 35,674,493
Accrued personnel costs	42,729,405	40,089,842
Accrued self-insurance liabilities (Note 11)	10,372,405	7,549,704
Payroll taxes and other payroll deductions	27,450,105	21,616,732
Deposits held for others	24,050,852	22,302,980
Deferred revenues (Note 1)	59,955,879	41,357,775
Current portion of long term debt and other obligations (Note 6)	3,946,495	3,165,000
Total current liabilities	198,562,768	171,756,526
Noncurrent liabilities:		
Accrued personnel costs	12,978,769	11,412,101
Accrued self-insurance liabilities (Note 11)	5,407,078	4,894,133
Long term debt and other obligations (Note 6)	256,384,345	234,791,436
Total noncurrent liabilities	274,770,192	251,097,670
Total liabilities	473,332,960	422,854,196
NET ASSETS		
Invested in capital assets, net of related debt	707,320,316	707,149,483
Restricted:		
Nonexpendable (Note 14)	224,251,956	211,697,524
Expendable (Note 14)	257,902,648	253,725,712
Unrestricted (Note 14)	451,462,174	414,793,928
Total net assets	1,640,937,094	1,587,366,647
Total liabilties and net assets	$ 2,114,270,054	$ 2,010,220,843

See accompanying notes

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
Michigan State University

	Year ended June 30, 2002	2001
OPERATING REVENUES		
Student tuition and fees	$ 287,153,010	$ 261,016,569
Less: scholarship allowances	33,064,366	29,343,864
Net student tuition and fees	254,088,644	231,672,705
State of Michigan grants and contracts	24,908,630	19,691,341
Federal grants and contracts	183,373,401	165,202,440
Local and private sponsored programs	49,044,467	43,121,313
Interest and fees on student loans	879,538	934,591
Departmental activities (net of scholarship allowances of $2,178,000 in 2002 and $1,848,000 in 2001)	91,320,556	96,324,418
Auxiliary activities (net of room and board allowances of $6,071,000 in 2002 and $6,432,000 in 2001)	188,622,973	168,214,888
Total operating revenues	792,238,209	725,161,696
OPERATING EXPENSES		
Instruction and departmental research	396,841,703	374,295,781
Research	201,077,342	185,074,470
Public services	155,778,736	136,791,344
Academic support	60,326,358	54,620,252
Student services	24,530,479	22,980,524
Scholarships and fellowships	24,041,329	21,621,088
Institutional support	56,077,542	53,789,809
Operation and maintenance of plant	82,790,956	77,325,228
Auxiliary enterprises	169,432,294	151,072,452
Depreciation	60,589,129	57,109,699
Other expenses	9,986,072	5,720,994
Total operating expenses	1,241,471,940	1,140,401,641
Operating income (loss)	(449,233,731)	(415,239,945)
NONOPERATING REVENUES (EXPENSES)		
State of Michigan appropriations	394,613,600	388,780,603
Gifts	29,854,418	40,423,242
Net investment income (loss)	41,954,862	60,256,370
Interest expense on capital asset related debt	(6,658,900)	(5,576,770)
Other revenues (expenses)	758,072	(851,461)
Net nonoperating revenues (expenses) before capital and endowment additions	460,522,052	483,031,984
State capital appropriations	12,317,246	47,534,432
Capital grants and gifts	6,321,904	13,392,803
Additions to permanent endowments	23,642,976	16,816,642
Net nonoperating revenues (expenses)	502,804,178	560,775,861
Increase (decrease) in net assets	53,570,447	145,535,916
Net assets - beginning of year, as restated (Note 16)	1,587,366,647	1,441,830,731
Net assets - end of year	$ 1,640,937,094	$ 1,587,366,647

See accompanying notes

STATEMENT OF CASH FLOWS
Michigan State University

	Year ended June 30, 2002	Year ended June 30, 2001
Cash flows from operating activities		
Tuition and fees	$ 255,578,268	$ 232,457,979
Research grants and contracts	269,231,201	226,551,119
Auxiliary activities	193,353,347	169,884,662
Departmental activities	95,122,252	91,741,370
Interest and fees on student loans	879,538	934,591
Loans issued to students	(7,815,369)	(9,494,242)
Collection of loans from students	9,474,726	7,959,027
Scholarships and fellowships	(25,266,216)	(23,164,160)
Payments to suppliers	(290,886,737)	(255,525,041)
Payments to employees	(848,781,548)	(798,405,424)
Other receipts (payments)	(3,879,431)	1,951,134
Net cash provided (used) by operating activities	(352,989,969)	(355,108,985)
Cash flows from noncapital financing activities		
State appropriations	393,553,056	383,987,076
Gifts	30,810,193	40,974,925
Endowment gifts	25,071,790	10,247,362
Net cash provided (used) by noncapital financing activities	449,435,039	435,209,363
Cash flows from capital and related financing activities		
Capital appropriations	19,119,686	54,330,236
Capital gifts and grants	7,281,327	8,796,069
Proceeds from issuance of debt and other long term obligations (1)	25,539,404	49,471,438
Purchase of capital assets	(124,777,726)	(123,483,364)
Gain (loss) on disposal of capital assets	758,072	(851,461)
Principal paid on capital debt	(3,165,000)	(3,055,000)
Interest paid	(6,015,576)	(5,677,341)
Net cash provided (used) by capital and related financing activities	(81,259,813)	(20,469,423)
Cash flows from investing activities		
Investment income, net	58,083,280	67,123,027
Proceeds from sales and maturities of investments	100,836,486	173,407,637
Purchase of investments	(212,357,935)	(251,936,261)
Net cash provided (used) by investing activities	(53,438,169)	(11,405,597)
Net increase (decrease) in cash	(38,252,912)	48,225,358
Cash - beginning of year	249,286,085	201,060,727
Cash - end of year	$ 211,033,173	$ 249,286,085

See accompanying notes

STATEMENT OF CASH FLOWS (Continued)
Michigan State University

Reconciliation of net operating income (loss) to net cash provided (used) by operating activities	**Year ended June 30, 2002**	**2001**
Operating income (loss)	$ (449,233,731)	$ (415,239,945)
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:		
Depreciation expense	60,589,129	57,109,699
Change in assets and liabilities:		
Accounts receivable	(429,746)	(6,708,774)
Student loans receivable	1,659,357	(1,535,215)
Inventories and other assets	402,399	(1,797,638)
Investments in joint ventures	(581,224)	(291,266)
Unamortized bond origination costs	22,498	(130,095)
Accounts payable	860,123	2,449,296
Accrued personnel costs	4,206,231	2,207,308
Payroll taxes and other payroll deductions	5,833,373	(1,167,654)
Deposits held for others	1,747,872	2,465,378
Deferred revenues	18,598,104	5,310,239
Accrued self-insurance liabilities	3,335,646	2,219,682
Net cash provided (used) by operating activities	$ (352,989,969)	$ (355,108,985)

(1) A capital lease obligation of $24,793,000 was incurred during fiscal year 2002 when the University entered into a long term building lease agreement.

1. Organization, basis of presentation, and summary of significant accounting policies

Organization:

Michigan State University (the "University") was founded in 1855 as the Agricultural College of the State of Michigan. It was the first institution of higher learning in the nation to teach scientific agriculture and, in 1863 became a pioneer land grant college under the Morrill Act. Michigan State has grown into a comprehensive research university providing undergraduate, graduate, and professional degree programs. While the University is a political subdivision of the State of Michigan, it is not a component unit of the State as defined by the Governmental Accounting Standards Board (GASB).

Basis of presentation:

The University follows all applicable GASB pronouncements. In addition, the University applies all applicable Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989 unless those pronouncements conflict with or contradict GASB pronouncements. The University has elected not to apply FASB pronouncements issued after November 30, 1989.

The accompanying financial statements have been prepared using the economic resource measurement focus and the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America for publicly owned colleges and universities and is presented in accordance with the reporting model as prescribed in Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments,* and GASB Statement No. 35*, Basic Financial Statements-and Management's Discussion and Analysis-for Public Colleges and Universities*, as amended by GASB Statements No. 37 and No. 38. The University has applied these standards on a retroactive basis. The University follows the "business-type" activities requirements of GASB Statement No. 34. This approach requires the following components of the University's financial statements:

- Management's Discussion and Analysis
- Basic Financial Statements including a Statement of Net Assets, Statement of Revenues, Expenses and Changes in Net Assets, and a Statement of Cash Flows for the University as a whole.
- Notes to Basic Financial Statements

GASB Statement No. 34 establishes standards for external financial reporting for public colleges and universities and requires that resources be classified for accounting and reporting purposes into the following four net asset categories:

- 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 constraints that they be maintained permanently by the University. Such assets include the University's permanent endowment funds.

    Expendable - Net assets whose use by the University is subject to externally imposed constraints that can be fulfilled by actions of the University pursuant to those constraints or that expire by the passage of time.

- Unrestricted: Net assets that are not subject to externally imposed constraints. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Trustees (the "Board") or may otherwise be limited by contractual agreements with outside parties. Substantially all unrestricted net assets are designated for academic and research programs and initiatives, and capital asset renewals and replacements.

The financial statements of all controlled organizations are required to be included in the University's financial statements; organizations which are not controlled by the University, such as the Michigan State University Foundation and booster organizations, are not included in the University's financial statements. There are no controlled organizations included in the University's financial statements for 2002 or 2001.

Summary of significant accounting policies:

Accrual accounting - The Statement of Net Assets and the Statement of Revenues, Expenses and Changes in Net Assets are prepared using the accrual basis of accounting.

Capital assets - Physical properties are stated at cost or, when donated, at fair market value at date of gift. Depreciation is computed using the straight-line method, with a full-year expense in the year of acquisition and none in the year of disposal. Assets are depreciated over the estimated useful lives ranging from four to forty years for the respective assets. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts. The University does not capitalize certain works of art or historical treasures (except for MSU Museum collections) that are held for exhibition, education, research and 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.

Inventories - Inventories are stated at the lower of average cost or market.

Income taxes - The University is classified as a political subdivision of the State of Michigan under Internal Revenue Code Section 115(a) and is therefore exempt from federal income taxes. Certain activities of the University may be subject to taxation as unrelated business income.

Investments - All investments are stated at fair value. Investments in publicly traded securities are stated at fair value as established by major securities markets. Non-publicly traded investments are valued based on independent appraisals and estimates considering market prices of similar investments.

Statement of Cash Flows - Operating cash and investments include highly liquid and short duration assets. These assets are treated as deposits that can be withdrawn on demand. For purposes of the Statement of Cash Flows, the University considers all operating cash and investments to be cash equivalents.

Compensated absences - University employees earn vacation and sick leave benefits based, in part, on length of service. Vacation pay is fully vested when earned. Upon separation from service, employees are paid accumulated vacation and sick pay based upon the nature of separation (death, retirement, or termination). Certain limitations have been placed on the hours of vacation and sick leave that employees may accumulate and carry over for payment at termination, retirement, or death. Unused hours exceeding these limitations are forfeited.

Eliminations - In preparing the basic financial statements, the University eliminates inter-fund assets and liabilities that would otherwise be reflected twice in the Statement of Net Assets. Similarly, revenues and expenses related to internal service activities are also eliminated from the Statement of Revenues, Expenses and Changes in Net Assets. Student tuition and residence fees are presented net of scholarships and fellowships applied to student accounts where the University has discretion over such expenses, while stipends and other payments made directly to students are presented as scholarship and fellowship expenses.

Operating and Nonoperating Revenues - 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 non-operating revenues, as defined by GASB Statement No. 34, including state appropriations, and gifts and investment income. Restricted and unrestricted resources are spent and tracked at the discretion of the University department within the guidelines of donor restrictions, if any.

Donor restricted endowments - For donor restricted endowments, the Uniform Management of Institutional Funds Act, as adopted in Michigan, permits the Board to appropriate an amount of realized and unrealized endowment appreciation as the Board determines to be prudent. Endowment realized and unrealized appreciation is reported consistent with the net asset categorization of the related endowment net of spending policy distributions. The Board chooses to spend only a portion of the investment income (including changes in the value of investments) each year. Under the spending policy established by the Board, 5.25% of the average market value of endowment investments for the twelve quarters of the three calendar years prior to the beginning of the fiscal year has been authorized for expenditure.

Deferred revenue - Deferred revenue consists primarily of advance ticket sales for athletic events, summer school tuition not earned during the current year, and contract and sponsored program advances.

Pledges - Financial support in the form of pledges is received from business enterprises, foundations and individuals. Revenue for gift pledges is recorded only when there is an unconditional promise to pay and all eligibility requirements, including time requirements, have been met. Contributions to permanent and term endowments are not recognized as an asset until the related gift is received.

Student tuition and fees - Student tuition and fee revenues are reported net of scholarship allowances in the Statement of Revenues, Expenses and Changes in Net Assets. Scholarship allowances are the difference between the stated charge for goods and services provided by the University and the amount that is paid by the students or third parties on behalf of the students, where the University has discretion of such expenses.

Auxiliary activities - Auxiliary activities mainly represent revenues generated from University Housing and Food Service, Intercollegiate Athletics, and various other departmental activities that provide services to the student body, faculty, staff and general public.

Use of estimates - The preparation of the 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 the accompanying notes. Actual results could differ from those estimates.

Reclassifications - Certain amounts from prior year have been reclassified to conform with the current year's presentation.

2. Operating cash and investments, Endowment and Other investments

Operating cash and investments - The University uses the "pooled cash" method of accounting for substantially all of its operating cash and investments, which as of June 30, 2002 and 2001 were as follows:

	2002	2001
Cash	$ (10,691,000)	$ (9,627,000)
Investments	179,479,000	220,624,000
Equity in pooled cash and investments	42,245,000	38,289,000
	$ 211,033,000	$ 249,286,000

The amount reported as investments for 2002 and 2001 consisted of fixed income instruments. Of the bank balances for cash and investments, $200,000 of the total $1,840,000 in 2002 and $201,000 of the total $878,000 in 2001 were covered by federal depository insurance. The remaining amounts were uninsured and uncollateralized, as banks holding deposits of the University are legally prohibited from collateralizing these deposits.

Investment policies for operating cash and investments, as set forth by the Board, authorize the University to invest in dollar-denominated, fixed-income instruments such as: obligations of the U.S. Government or its agencies; securities of United States and foreign issuers including corporations and quasi-government entities; mortgage pass-through and collateralized mortgage obligations; asset-backed securities; money market instruments, and commingled, global, and international funds offered by the University's investment manager. All securities will be purchased to maintain a minimum average portfolio quality rating of A.

The yields on operating cash and investments were 6.2% in 2002 and 9.1% in 2001.

Endowment and Other investments - Policies regarding long term investments and marketable securities, as set forth by the Board, authorize the University to invest in bonds with a weighted average credit quality rating of investment grade, commercial paper normally rated no lower than the second highest grade of Moody's or Standard & Poor's, certificates of deposit issued by either U.S. chartered banks with a debt rating of A or better, or foreign chartered banks meeting management's standards. Investments held in pools not registered with the SEC are managed and monitored by an independent consulting firm retained by the University.

The investments are categorized below to give an indication of the level of custodial credit risk assumed by the University as of June 30, 2002 and 2001. Category A includes insured or registered securities held in the University's name. Category B includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by its trust department or agent, in the University's name. Category C includes uninsured and unregistered investments for which the securities are held by the broker or dealer, or by its trust department or agent, but not in the University's name.

	2002 Categories			
	A	B	C	Total
U.S. Government securities	$ -	$ 171,000	$ 11,970,000	$ 12,141,000
Notes and bonds	-	-	565,000	565,000
Equities	-	-	154,443,000	154,443,000
	$ -	$ 171,000	$ 166,978,000	$ 167,149,000

	2001 Categories			
	A	B	C	Total
U.S. Government securities	$ -	$ 170,000	$ 5,981,000	$ 6,151,000
Notes and bonds	-	-	827,000	827,000
Equities	-	-	154,304,000	154,304,000
	$ -	$ 170,000	$ 161,112,000	$ 161,282,000

In addition to the above, the University has pooled investments held by several trust companies that are managed by independent investment managers. These investments, net of certain restricted debt service reserve investments, totaled $590,081,000 and $499,544,000 as of June 30, 2002 and 2001, respectively.

The University also held miscellaneous assets of $2,914,000 and $2,152,000 at June 30, 2002 and 2001, respectively. Miscellaneous assets consist substantially of annuities for benefit payments and real estate.

Investment performance: The University pools substantially all of its long-term investments and marketable securities in its Common Investment Fund. Due to legal and operating requirements, certain other investments are invested separately or in the University's

Base Cash Pool. The total return (includes ordinary income as well as realized and unrealized gains and losses) on investments and marketable securities, for the years ended June 30, 2002 and 2001 were as follows:

	2002	2001
Common Investment Fund	2.3%	5.7%
Base Cash Pool	9.8%	9.6%
Other	-8.1%	-10.4%

Off-balance sheet risk - The University's investment strategy incorporates certain financial instruments which 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 rate fluctuations embodied in forward, futures, commodity or security prices. Market risk is directly impacted by the volatility and liquidity of the markets in which the related underlying assets are traded. Credit risk is the possibility that a loss may occur due to the failure of the counterparty to perform according to the terms of the contract. The University's risk of loss in the event of 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.

3. Accounts and interest receivable

The composition of accounts and interest receivable at June 30, 2002 and 2001 is summarized as follows:

	2002	2001
State operating appropriations	$ 71,748,000	$ 70,687,000
Research and sponsored programs	31,919,000	29,268,000
Departmental activities	12,208,000	14,332,000
State capital appropriations	6,715,000	13,518,000
Interest receivable	2,234,000	3,774,000
Other	7,627,000	8,299,000
	132,451,000	139,878,000
Less allowance for doubtful accounts	8,048,000	8,623,000
Net accounts and interest receivable	$ 124,403,000	$ 131,255,000

4. Student loans receivable

Student loans receivable at June 30, 2002 and 2001 include allowances for uncollectable loans of $3,860,000 and $3,925,000, respectively. Principal repayment and interest rate terms of federal and university loans vary considerably. Federal loan programs are funded principally with federal contributions to the University under the Perkins and various health professions loan programs.

The University distributed $147,185,000 for student loans through the U.S. Department of Education federal direct lending program. These distributions and related funding sources are not included as expenses and revenues or as cash disbursements and cash receipts in the accompanying financial statements.

5. Pledges receivable

Payments on pledges receivable at June 30, 2002, expected to be received in the following fiscal years ended June 30, are summarized below. The allowance for uncollectable pledges receivable is made based on prior collection experience and management judgement. Gift pledges expected to be collected in the future years are reported at the net present value of the related cash flows discounted at 5.0%.

2003	$ 14,749,000
2004	6,136,000
2005	4,985,000
2006	2,094,000
2007	1,269,000
2008 and beyond	3,252,000
Total discounted pledges receivable	32,485,000
Less allowance for uncollectible pledges	3,385,000
Net pledges receivable	$ 29,100,000

6. Long term debt and other obligations

Bonds payable at June 30, 2001 and 2002 are summarized as follows:

	2001	Borrowed	Retired	2002
General Revenue Bonds, Series 2000A-2	$ 48,835,000	$ -	$ -	$ 48,835,000
General Revenue Bonds, Series 2000A-1	61,165,000	-	-	61,165,000
General Revenue Bonds, Series 1998A-2	51,935,000	-	-	51,935,000
General Revenue Bonds, Series 1998A-1	17,480,000	-	1,855,000	15,625,000
General Revenue Bonds, Series 1996A	26,270,000	-	1,310,000	24,960,000
	$ 205,685,000	$ -	$ 3,165,000	$ 202,520,000

The Series 2000A-2 bonds, secured by General Revenues (primarily unrestricted operating revenues), bear interest based on a weekly rate determined by the remarketing agent and are amortized through mandatory redemptions from fiscal 2007 through 2031. The Series 2000A-2 bonds may be converted to a permanent fixed rate provided certain conditions are met.

The Series 2000A-1 bonds, secured by General Revenues, bear interest based on a weekly rate determined by the remarketing agent and are amortized through mandatory redemptions from fiscal 2006 and 2031. The Series 2000A-1 bonds may be converted to a permanent fixed rate provided certain conditions are met.

During 2002, the University entered into a swap transaction related to $98,545,000 of the Series 2000A bonds. This has the effect of creating fixed rate bonds that bear interest at 4.07% through fiscal 2030.

The Series 1998A-2 bonds, secured by General Revenues, bear interest based on a weekly rate determined by the remarketing agent and are amortized through mandatory sinking fund redemptions from fiscal 2010 through 2023. In connection with the issuance of the Series 1998A-2 bonds, the University entered into a swap transaction. This has the effect of creating fixed rate bonds that bear interest at 4.60% through fiscal 2009. The Series 1998A-2 bonds may be converted to a permanent fixed rate provided certain conditions are met.

The Series 1998A-1 bonds, secured by General Revenues, bear interest at rates varying from 4.25% to 5.00% and mature serially through fiscal 2009.

The Series 1996A bonds, secured by General Revenues, bear interest at rates varying from 4.55% to 6.00% and mature serially through fiscal 2026.

Interest expense was $6,659,000 and $5,577,000 for 2002 and 2001, respectively, net of capitalized interest of $779,000 for 2002 and $1,236,000 for 2001. Scheduled fiscal year maturities of bonds payable and related interest expense are as follows:

	Principal (in thousands)	Interest
2003	$ 2,970,000	$ 8,780,000
2004	3,095,000	8,668,000
2005	2,725,000	8,508,000
2006	3,105,000	8,382,000
2007	4,215,000	8,224,000
2008-2012	24,395,000	37,958,000
2013-2017	31,040,000	31,721,000
2018-2022	39,450,000	23,833,000
2023-2027	48,890,000	14,017,000
2028-2031	42,635,000	3,580,000
	$ 202,520,000	$ 153,671,000

In addition to bonds payable, the University had long term lease obligations of $24,793,000 at June 30, 2002 and federal student loan deposits of $33,018,000 and $32,271,000 from the federal government related to various federal student loan programs for the years ended June 30, 2002 and 2001, respectively.

7. Retirement benefits

The University has a defined contribution base retirement plan administered through the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF), Fidelity Investments and The Vanguard Group for all qualified employees. All regular employees are eligible to participate based on the service requirements specific to their employee group. Participants maintain individual contracts with the base retirement vendors and are fully vested.

Participating employees contribute 5% of their base salary or wages and the University contributes 10% of the employee's base salary or wages subject to applicable Internal Revenue Service limits. Participants may elect to contribute additional amounts to a supplemental plan, within specified limits, which are not matched by University contributions. Plan provisions and contribution requirements of plan members and the University are established and may be amended by the Board in accordance with University policies, union contracts, or plan provisions. Contributions under the base plan, excluding the participants' supplemental contributions, for the years ended June 30, were as follows:

	2002	2001
University contributions	$ 48,072,000	$ 45,710,000
Employee contributions	24,036,000	22,855,000

In addition, the University has a single-employer, defined benefit plan covering approximately 1,300 employees hired prior to January 1, 1973. This plan is closed to new entrants and is fully funded. The benefits are based on the employee's compensation during the last three years of employment and/or years of service. There were no required annual contributions and no pension costs for each of the three preceding years ended June 30, 2002.

The University also funds termination benefits upon retirement resulting from certain other separation benefits.

8. Other post employment benefits

In addition to providing retirement benefits, the University contributes monthly health care and dental premiums for retired employees. Substantially all of the University's employees may become eligible for those benefits if they meet normal retirement requirements while still working for the University. The number of eligible retirees was approximately 3,700 in 2002 and 3,500 in 2001. The University recognizes the cost of providing those benefits on a pay-as-you-go basis. Those costs totaled $16,829,000 for 2002 and $14,591,000 for 2001 and are included in operating expenses in the Statement of Revenues, Expenses and Changes in Net Assets.

9. Grants and contracts

The University receives grants and contracts from certain federal, state, and local agencies to fund research and other activities. Revenues from government grants and contracts are recognized when all eligibility requirements have been met. The University records indirect costs related to such grants and contracts at predetermined rates that are negotiated with the University's federal cognizant agency. Both direct and indirect costs charged to the grants or contracts are subject to audit and approval by the granting agencies. University management believes any adjustments of costs resulting from such examination by the granting agency would be insignificant.

10. Commitments

At June 30, 2002, the University had initiated plans and incurred certain contractual commitments related to the construction or capital improvement of various facilities. The costs to complete the projects are estimated to be $42,496,000 and are to be funded from state and State Building Authority (SBA) appropriations, private gifts, debt proceeds or other University funds. Certain University facilities, including the Crop and Soil Sciences Research Facility, the Revitalization of the Michigan Animal Agriculture Facilities, the Engineering Research Complex, the Biomedical and Physical Sciences Building, and the Animal Health Diagnostic Laboratory have been, or are scheduled to be, financed in whole or in part by SBA bond issues which are secured by a pledge of rentals to be received from the State of Michigan pursuant to lease agreements between the SBA, the State of Michigan, and the University. During the lease terms, the SBA will hold title to the respective buildings, the State of Michigan will make all lease payments to the SBA and the University will pay all operating and maintenance costs. At the expiration of the individual leases, the SBA has agreed to sell each building to the University for one dollar.

At June 30, 2002, the University had entered into various limited partnerships with investment managers of oil and gas, venture capital, private equity and real estate funds. As of June 30, 2002, $53,667,000 of the initial $89,500,000 investment commitment remains outstanding.

11. Contingencies and risk management

The University is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; and natural disasters. To manage these risks, the University uses commercial insurance with various self-insured retentions. Self-insured amounts are computed based on historical claim experience.

The University's liability for various medical professional liability claims is funded based on actuarial valuations. Subsequent to February 1981, the University is indemnified by the State of Michigan for any losses in excess of the actuarially determined funded reserves. Beginning July 1, 1995, the University purchased excess commercial medical professional liability insurance to manage the liability. The liability is reported at its present value of $5,560,000 as of June 30, 2002. The discount rate used was 5.0%.

The University is also self-insured for various employee benefits which include healthcare and dental insurance, workers compensation and unemployment compensation. Claims expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Those losses include an estimate of claims that have been incurred but not reported. The workers compensation liability, which will be settled by fixed payments over an extended period of time, is reported at its present value of $1,946,000. The discount rate used was 6.0%.

At June 30, 2002, these general, professional, and self-insured employee benefit liabilities totaled $15,779,000. Changes in the total reported liabilities during fiscal 2002 and 2001 were as follows:

	2002	2001
Balance at beginning of year	$ 12,444,000	$ 12,395,000
Claims incurred and changes in estimates	62,952,000	50,494,000
Claim payments	(59,617,000)	(50,445,000)
Balance at the end of year	$ 15,779,000	$ 12,444,000

For those risks that the University has purchased commercial insurance, settled claims have not exceeded the commercial coverage in any of the past three years.

In the normal course of its activities, the University has been a party in various legal actions. Historically, the University has not experienced significant losses from such actions. After taking into consideration legal counsel's evaluation of pending actions, the University is of the opinion that the outcome thereof will not have a material effect on the financial statements.

12. Related organizations and joint ventures

Michigan State University Foundation is an independent corporation formed for the purpose of receiving funds for the sole benefit of the University. At June 30, 2002, the stated value of the net assets of the Foundation approximated $277,776,000. These assets are not included in the financial statements of the University. Contributions to and payments on behalf of the University approximated $24,664,000 in 2002 and $38,829,000 in 2001.

The University is a party to joint ventures with three separate enterprises. The joint venture Mid-Michigan MRI with Sparrow Health System operates a magnetic resonance imaging facility. The University has a 50% equity share of cumulative Mid-Michigan MRI net income. The University Rehabilitation Alliance, Inc., a joint venture with Peckham Vocational Industries of Lansing, is an enterprise for the treatment of persons with brain injury. The University's equity share in this joint venture is 50%. The University has a 33% equity investment in the Radiation Oncology Alliance, a joint venture with Michigan Affiliated Health Care System and the University of Michigan. Copies of financial statements for the above joint ventures can be obtained by a written request to: Office of the Controller, Michigan State University, Room 305 John A. Hannah Administration Building, East Lansing, Michigan 48824-1046.

13. Capital assets and collections

Capital asset and collection activity for the year ended June 30, 2002 was as follows:

	Balance June 30, 2001	Additions	Disposals	Balance June 30, 2002
Non-depreciated capital assets:				
Land	$ 17,767,000	$ 1,450,000	$ -	$ 19,217,000
Construction in progress	122,773,000	(76,221,000)	-	46,552,000
Collections	4,328,000	179,000	-	4,507,000
	144,868,000	(74,592,000)	-	70,276,000
Depreciated capital assets:				
Buildings and site improvements	1,089,611,000	168,492,000	1,147,000	1,256,956,000
Equipment and other	385,990,000	25,649,000	16,036,000	395,603,000
Accumulated depreciation	(750,547,000)	(60,589,000)	(15,058,000)	(796,078,000)
	725,054,000	133,552,000	2,125,000	856,481,000
Total capital assets	$ 869,922,000	$ 58,960,000	$ 2,125,000	$ 926,757,000

14. Net assets

A summary of restricted and unrestricted net assets is as follows:

	2002	2001
Restricted - nonexpendable:		
Permanent endowments	$ 224,252,000	$ 211,698,000
Restricted - expendable:		
Gifts, endowment income and sponsored programs	$ 118,415,000	$ 114,263,000
Quasi and term endowments	109,783,000	107,712,000
Capital projects	22,911,000	25,360,000
Student loans	6,794,000	6,391,000
Total	$ 257,903,000	$ 253,726,000
Unrestricted:		
Designated	$ 446,789,000	$ 410,841,000
Uncommitted	4,673,000	3,953,000
Total	$ 451,462,000	$ 414,794,000

Restricted - Net assets are restricted when they are subject to externally imposed constraints.

Unrestricted - Unrestricted net assets are not subject to externally imposed constraints; however, they are subject to internal designations. Unrestricted net assets include amounts designated for specific purposes by action of the Board or management or may otherwise be subject to pending contractual commitments with external parties. Substantially all unrestricted net assets are internally designated for programmatic initiatives or capital asset renewals.

15. Subsequent event

On August 8, 2002, the University issued $53,780,000 of General Revenue Bonds Series 2002A and $11,480,000 of General Revenue Bonds Series 2002B, the proceeds of which are to be used to fully or partially fund certain capital projects. The Series 2002A bonds, secured by General Revenues, bear interest based on a daily rate determined by the remarketing agent and are amortized through mandatory redemptions from fiscal 2006 through 2033. The Series 2002A bonds may be converted to a permanent fixed rate provided certain conditions are met. The Series 2002B bonds, secured by General Revenues, bear interest based on a weekly rate determined by the remarketing agent and are amortized through mandatory redemptions from fiscal 2006 through 2023. In the opinion of legal counsel, the interest earned by bondholders on the Series 2002B bonds is subject to federal income tax. The Series 2002B bonds may be converted to a permanent fixed rate provided certain conditions are met.

16. Accounting change

Effective with the fiscal year ended June 30, 2002, the University adopted GASB Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, and GASB Statement No. 35, *Basic Financial Statements-and Management's Discussion and Analysis-for Public Colleges and Universities*, as amended by GASB Statements No. 37 and No. 38, and applied those standards on a retroactive basis, as of July 1, 2000.

The following is a reconciliation of total June 30, 2001 and June 30, 2000 combined fund balances, as previously reported, to the restated net asset balance for the same periods:

	2001	2000
Combined fund balances, as previously reported	$ 1,633,508,000	$ 1,464,715,000
Reclass federal portion of student loans	(32,271,000)	(31,635,000)
Net pledges and other receivables	-	21,830,000
Deferred revenue	(16,005,000)	(13,210,000)
Interest receivable and payable (net)	2,135,000	131,000
Combined fund balances, restated as net assets	$ 1,587,367,000	$ 1,441,831,000

Report prepared by Marketing and Creative Services, Division of University Relations, under the direction of Fred L. Poston, Vice President for Finance and Operations and Treasurer; David B. Brower, Assistant Vice President, Chief Financial Officer and Controller; Glen J. Klein, Director of Investments and Financial Management; Vincent Schimizzi, Chief Accountant; and Gregory J. Deppong, Manager of Financial Analysis.

Suite 1200
150 West Jefferson
Detroit, MI 48226-4429

Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Board of Trustees
Michigan State University:

We have audited the basic financial statements of Michigan State University (the University) as of and for the year ended June 30, 2002, and have issued our report thereon dated August 30, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the University's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the board of trustees, management, and federal awarding agencies and pass-through entities, and is not intended to be, and should not be, used by anyone other than these specified parties.

KPMG LLP

August 30, 2002