MICHIGAN STATE
UNIVERSITY

FINANCIAL REPORT

2002-2003

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MICHIGAN STATE
UNIVERSITY

This report presents the financial position and results of operations of Michigan State University for the fiscal years ended June 30, 2003, and June 30, 2002. 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 23 have been audited by KPMG LLP, Certified Public Accountants. Their audit report appears on page 9.

Michigan State University has been advancing knowledge and transforming lives through innovative teaching, research, and outreach for nearly 150 years. MSU enrolls more than 44,000 students in 200 programs of undergraduate and graduate study, and 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. Strong recruiting efforts yielded a fall 2002 freshman class with an average high school GPA of 3.56 and an average ACT score of 24.3, both up from the preceding year.

Despite difficult financial times which resulted in mid-year state appropriation rescissions totaling 3.5% and a further reduction in the 2003-04 appropriation of 6.5%, MSU made the necessary fiscal adjustments through a series of strategies with the objective of maintaining quality and balancing the budget. This was 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.

In an effort to broaden its revenue base, the University continues The Campaign for MSU, a comprehensive fundraising initiative with a goal to generate $1.2 billion by 2007. As of June 30, 2003, the amount raised to date exceeded $700 million.

Several projects were undertaken and a number were completed in 2002-03 to enhance MSU facilities and the services they provide, both to the campus and to the community at large. A noninvasive means to detect cancer and an expansion for international programs were among the completed developments. The positron emission tomography – or PET – cyclotron, which is located in the MSU Radiology Center, is an increasingly popular option for the detection of early-stage tumors and monitoring the effectiveness of cancer treatment therapies. The Delia Koo International Academic Center, which includes a 12,000 square foot third-floor addition to the International Center, was made possible by a gift from Delia Koo, an MSU alumna and longtime supporter of MSU's international mission.

At its founding in 1855, MSU was an experiment in higher learning, offering to all qualified applicants an education that was both liberal and practical. Today, as it continues to help students become responsible, knowledgeable, productive citizens, MSU is a major public university with global reach and extraordinary impact. Sustaining – and enhancing – that reach and impact through innovative initiatives is MSU's challenge as it looks ahead to its sesquicentennial year and beyond.

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

OFFICE OF THE
VICE PRESIDENT FOR FINANCE AND OPERATIONS AND TREASURER

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Michigan State University

Introduction

The University's annual report consists of three basic financial statements: the Statement of Net Assets, which presents the assets, liabilities, and net assets of the institution as of the end of the fiscal year; the Statement of Revenues, Expenses, and Changes in Net Assets, which reflects revenues and expenses recognized during the fiscal year; and the Statement of Cash Flows, which provides information on all of the cash inflows and outflows for the institution by major category during the fiscal year. These financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) pronouncements.

The following discussion and analysis provides an overview of the financial position and activities of Michigan State University (the "University" or "MSU") for the years ended June 30, 2003 and 2002. 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.

The University faced challenges posed by a weak economy, mid-year state appropriation decreases, rising health care costs, and facility renovation and maintenance requirements. Ongoing internal budget reductions and reallocations focused resources in strategic and opportunistic mission priorities. Moreover, these financial statements reflect campus-wide departmental savings in anticipation of significant budget reductions in the 2003-04 fiscal year. During the 2002-03 fiscal year, MSU units were instructed to effect cuts early and to accumulate funding where possible for bridging the anticipated 2003-04 reductions.

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 are 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, 2003, 2002, and 2001 follows:

	2003	2002 (in millions)	2001
Current assets	$ 364	$ 371	$ 417
Noncurrent assets:			
Endowment and other investments	874	764	663
Capital assets, net	952	927	870
Other	57	52	60
Total assets	2,247	2,114	2,010
Current liabilities	208	198	172
Noncurrent liabilities	321	275	251
Total liabilities	529	473	423
Total net assets	$ 1,718	$ 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 facilities. The University's Statement of Net Assets at June 30, 2003 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 $364 million and $371 million at June 30, 2003 and 2002, respectively. The net $7 million decrease in 2003 primarily represents the reallocation of $60 million of operating cash and investments to designated endowment investments (consistent with the University's cash management and investment plan) and an $11 million reduction in accounts receivable as a result of decreased State of Michigan operating and capital appropriations. These decreases are offset by the receipt of $65 million of debt proceeds from the Series 2002 bond issue. The $46 million decrease in 2002 primarily represents the reallocation of certain operating cash and investments to designated endowment investments, consistent with the University's cash management and investment plan.

Noncurrent assets:

Endowment and other investments

At June 30, 2003 and June 30, 2002, the University's endowment investments totaled $602 million (an increase of $91 million) and $511 million (an increase of $90 million), respectively. During both 2003 and 2002, $60 million of operating cash and investments was reallocated to establish the aforementioned designated endowments. Gifts to permanent endowments of $14 million and $24 million in 2003 and 2002, respectively, and the market value increase within the investment portfolio accounted for the majority of the remaining increases in 2003 and 2002.

Other investments consist primarily of the University's Operating Cash Pool's total return-oriented bond portfolio which totaled $186 million and $170 million at June 30, 2003 and 2002, respectively. Funded retirement and post-employment benefit reserves ($66 million in 2003 and $61 million in 2002) substantially account for the remainder of other investments.

Capital assets

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, 2003, 2002, and 2001, the University's investment in capital assets were as follows:

	2003	2002	2001
		(in millions)	
Land	$ 19	$ 19	$ 18
Buildings and site improvements	1,333	1,257	1,090
Construction in progress	26	47	123
Equipment and other	421	396	386
Capital assets not depreciated	5	4	4
Less: accumulated depreciation	(852)	(796)	(751)
	$ 952	$ 927	$ 870

Major capital additions during 2003 included the $21 million Shaw Lane Parking Ramp and $7 million each in renovations to Jenison Field House, the Clinical Center - Radiopharmaceutical addition, and the third-floor addition to the Delia Koo International Academic Center.

Major capital additions during 2002 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, 2003, 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 $68 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.

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 $208 million at June 30, 2003, compared to $198 million at June 30, 2002. The net increase in current liabilities at June 30, 2003 is due primarily to an increase of $2 million each in deferred revenues for summer semester tuition and sponsored programs, and withholdings for payroll taxes and employee fringe benefits. At June 30, 2002, the net increase in current liabilities was primarily due to deferred revenues in sponsored programs, which increased $14 million.

Noncurrent liabilities, primarily debt:

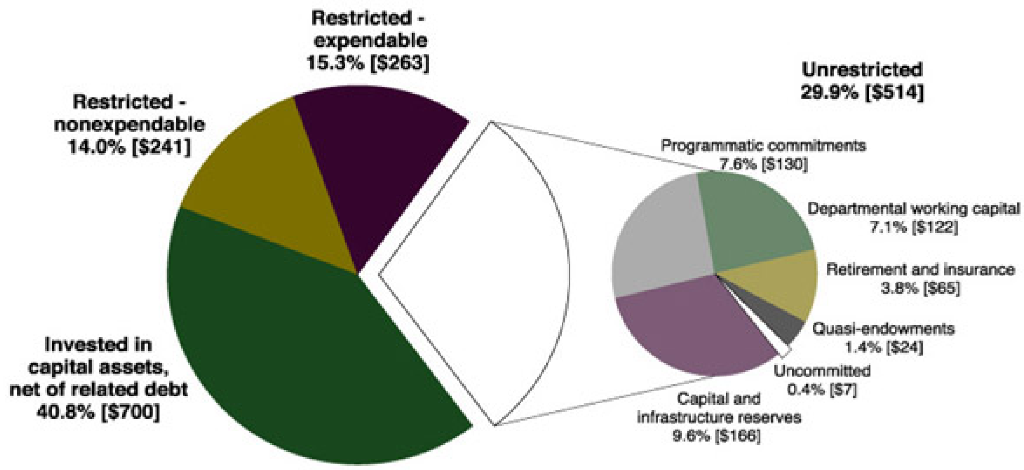
At June 30, 2003, the University had noncurrent debt and other obligations outstanding of $296 million compared with $256 million at June 30, 2002. This balance is comprised primarily of outstanding General Revenue Bonds of $260 million and $200 million in 2003 and 2002, respectively, a net increase largely due to the issuance of General Revenue Bonds, Series 2002A ($54 million) and 2002B ($11 million) in August, 2002. 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.

Net assets:

Net assets represent residual University assets after liabilities are deducted. The University's net assets at June 30, 2003, 2002, and 2001 are summarized as follows:

	2003	2002	2001
		(in millions)	
Invested in capital assets, net of related debt	$ 700	$ 707	$ 707
Restricted:			
Nonexpendable	241	225	211
Expendable	263	258	254
Total restricted	504	483	465
Unrestricted	514	451	415
Total net assets	$ 1,718	$ 1,641	$ 1,587

The following is a breakdown of net assets at June 30, 2003 (amounts are presented in millions of dollars):



TOTAL NET ASSETS $1.7 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, 2003, total uncommitted, unrestricted net assets equaled $6.9 million (.4% of total net assets). This balance is earmarked for transition support to accommodate anticipated 2003-04 budget reductions. Total uncommitted, unrestricted net assets at June 30, 2002 equaled $4.7 million (.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 increasing health care and dental benefits costs. This includes the cost of providing post employment health and dental benefits to eligible employees. Under current governmental 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.

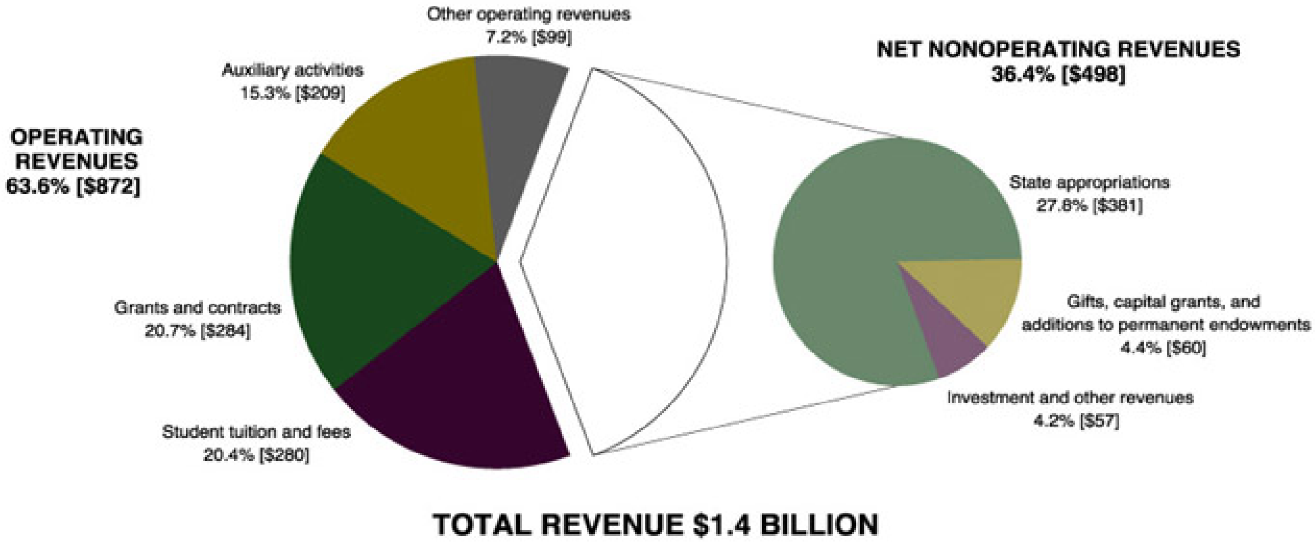
Statement of Revenues, Expenses, and Changes in Net Assets

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 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, 2003, 2002, and 2001 follows:

	2003	2002	2001
		(in millions)	
Operating revenues:			
Student tuition and fees, net of allowances	$ 280	$ 254	$ 232
Grants and contracts	284	257	228
Auxiliary activities	209	189	168
Other operating revenues	99	92	97
Total operating revenues	872	792	725
Operating expenses:			
Instruction and departmental research	406	397	374
Research	214	201	185
Public services	158	156	137
Academic support	58	60	54
Student services	25	24	23
Scholarships and fellowships	24	24	22
Institutional support	59	56	54
Operation and maintenance of plant	86	83	77
Auxiliary enterprises	185	169	151
Depreciation	70	61	57
Other expenses	8	10	6
Total operating expenses	1,293	1,241	1,140
Operating loss	(421)	(449)	(415)
Nonoperating revenues (expenses):			
State appropriations	381	395	389
Gifts	39	30	40
Net investment income	61	42	60
Interest expense on capital asset related debt	(6)	(7)	(6)
Other net revenues (expenses)	2	1	(1)
State capital appropriations	-	12	48
Capital grants and gifts	7	6	13
Additions to permanent endowments	14	24	17
Net nonoperating revenues	498	503	560
Increase in net assets	77	54	145
Net assets beginning of year	1,641	1,587	1,442
Net assets end of year	$ 1,718	$ 1,641	$ 1,587

The following is a graphic illustration of total revenue by source for the year ended June 30, 2003 (amounts are presented in millions of dollars):

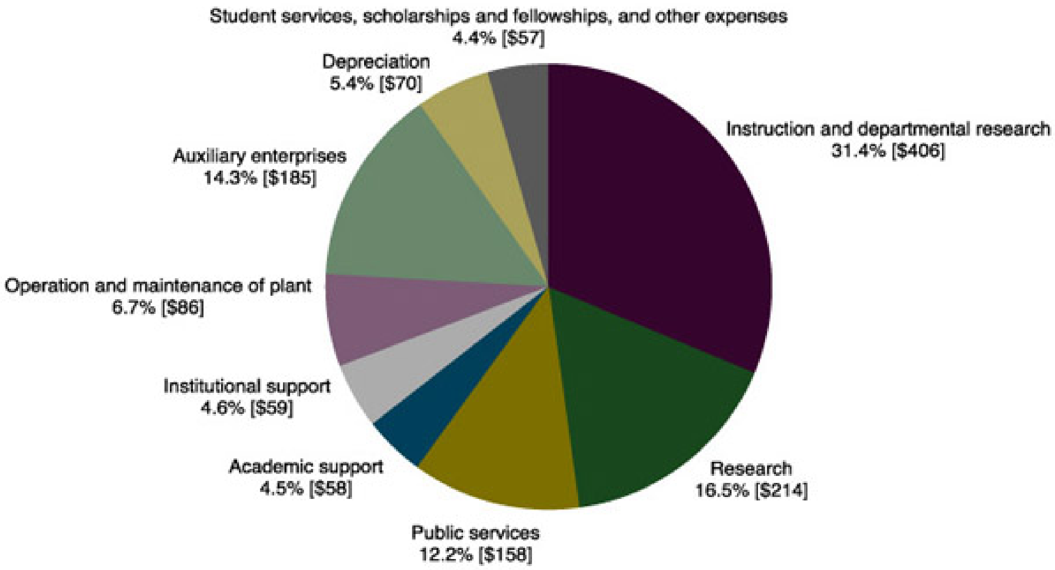


The University is supported by a diverse stream of revenue which supplements its student tuition and fees, including state appropriations, federal and state sponsored programs, private gifts and grants and investment income. The University continues to seek funding from all possible sources consistent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

Operating revenues for 2003 totaled $872 million compared with $792 million for 2002. The most significant source of operating revenue for the University was tuition and fees (net of scholarship allowances) totaling $280 and $254 million at June 30, 2003 and June 30, 2002, respectively. The 10.7% increase in gross tuition and fees revenue in 2003 reflects an 8.4% rate increase in tuition and fees and a 2.3% revenue increase from additional student credit hours taken. The increase in 2002, 10.0%, 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 in 2003 include auxiliary services of $209 million ($189 million in 2002) and federal grants and contracts of $199 million ($183 million in 2002).

Net nonoperating revenues totaled $498 and $503 million for the years ended June 30, 2003 and June 30, 2002, respectively. The primary source of this revenue is state appropriations, which totaled $381 million for 2003 and $395 million for 2002. State appropriations decreased $14 million (3.5%) in 2003 via unscheduled mid-year budget rescissions by the State of Michigan. In 2002, appropriations increased a planned $6 million (1.5%). Increases in gift revenue ($9 million) and net investment income ($19 million) primarily account for the increase in net nonoperating revenues in 2003, whereas decreases in gift revenue ($10 million), net investment income ($18 million), and state capital appropriations ($36 million) primarily account for the decline in net nonoperating revenues in 2002.

The following is a graphic illustration of operating expenses by source for the year ended June 30, 2003 (amounts are presented in millions of dollars):



TOTAL OPERATING EXPENSES $1.3 BILLION

Operating expenses in 2003, including depreciation of $70 million, totaled $1.3 billion compared to $1.2 billion for 2002. During 2003, $778 million (60.2%) was expended for the core missions of the University, instruction and departmental research, research and public services, compared with $754 million (60.8%) in the prior year. Auxiliary enterprises (activities which provide services to students, faculty, staff, and the public) totaled $185 million (14.3%) and $169 million (13.6%) in 2003 and 2002, respectively.

Economic Outlook

As a result of economic pressures affecting the State of Michigan, 2003-04 fiscal year state appropriations have been reduced 6.5% ($25 million). This decrease, combined with the aforementioned 3.5% ($14 million) reduction during fiscal year 2002-03 has resulted in a 10.0% cut totaling $39 million for MSU, MSU Extension, and the Agricultural Experiment Station. In response to the decreases in appropriations, internal general operating budget reductions totaling $14 million were taken in 2003 and further budget cuts of $31 million have been implemented for 2004. Additionally, the University's Board of Trustees approved a 9.9% increase for fall 2003 in-state tuition and required fees. The University's economic future is in part tied to that of the state, as there is a direct relationship between the amount of state appropriations and the increase in tuition and fee levels.

In an effort to broaden its revenue base, the University continues The Campaign for MSU, a comprehensive fund-raising initiative with a goal to generate $1.2 billion by 2007. As of June 30, 2003, $708 million had been raised including cash, in-kind gifts, pledges, irrevocable life income agreements, and bequest commitments.

KPMG

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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, 2003 and 2002, as listed in the table of contents. 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 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 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. 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 the University as of June 30, 2003 and 2002, 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.

In accordance with *Government Auditing Standards,* we have also issued a report dated August 29, 2003 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 results of our audit.

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 accounting principles generally accepted in the United States of America. 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 29, 2003

STATEMENTS OF NET ASSETS
Michigan State University

	June 30, 2003	June 30, 2002
ASSETS		
Current assets:		
Operating cash and investments (Note 2)	$ 216,192,712	$ 211,033,173
Accounts and interest receivable, net (Note 3)	113,585,644	124,402,795
Student loans receivable, net (Note 4)	9,392,568	8,267,483
Pledges receivable, net (Note 5)	11,537,276	13,216,187
Inventories and other assets	13,697,282	13,689,531
Total current assets	364,405,482	370,609,169
Noncurrent assets:		
Endowment investments (Note 2)	601,866,304	511,434,742
Other investments (Note 2)	271,993,848	253,243,366
Student loans receivable, net (Note 4)	29,589,970	27,535,664
Pledges receivable, net (Note 5)	19,168,765	15,884,275
Investments in joint ventures (Note 12)	6,125,580	6,944,220
Unamortized bond origination costs	2,117,714	1,861,997
Capital assets, net (Note 13)	951,513,600	926,756,621
Total noncurrent assets	1,882,375,781	1,743,660,885
TOTAL ASSETS	**$ 2,246,781,263**	**$ 2,114,270,054**
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts and interest payable	$ 30,203,418	$ 30,057,627
Accrued personnel costs	45,234,580	42,729,405
Accrued self-insurance liabilities (Note 11)	11,353,405	10,372,405
Payroll taxes and other payroll deductions	29,334,128	27,450,105
Deposits held for others	23,441,018	24,050,852
Deferred revenues	64,978,300	59,955,879
Current portion of long term debt and other obligations (Note 6)	3,770,656	3,946,495
Total current liabilities	208,315,505	198,562,768
Noncurrent liabilities:		
Accrued personnel costs	18,322,631	12,978,769
Accrued self-insurance liabilities (Note 11)	6,000,862	5,407,078
Long term debt and other obligations (Note 6)	296,270,208	256,384,345
Total noncurrent liabilities	320,593,701	274,770,192
Total liabilities	**528,909,206**	**473,332,960**
Net assets:		
Invested in capital assets, net of related debt	700,048,848	707,320,316
Restricted:		
Nonexpendable (Note 14)	240,681,394	224,251,956
Expendable (Note 14)	263,063,496	257,902,648
Unrestricted (Note 14)	514,078,319	451,462,174
Total net assets	**1,717,872,057**	**1,640,937,094**
TOTAL LIABILITIES AND NET ASSETS	**$ 2,246,781,263**	**$ 2,114,270,054**

See accompanying notes

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

	Year ended June 30, 2003	2002
OPERATING REVENUES		
Student tuition and fees	$ 317,842,043	$ 287,153,010
Less: scholarship allowances	37,446,679	33,064,366
Net student tuition and fees	280,395,364	254,088,644
State of Michigan grants and contracts	34,240,493	24,908,630
Federal grants and contracts	199,097,607	183,373,401
Local and private sponsored programs	50,556,490	49,044,467
Interest and fees on student loans	795,291	879,538
Departmental activities (net of scholarship allowances of $2,352,000 in 2003 and $2,178,000 in 2002)	98,160,162	91,320,556
Auxiliary activities (net of room and board allowances of $6,590,000 in 2003 and $6,071,000 in 2002)	208,940,004	188,622,973
TOTAL OPERATING REVENUES	**872,185,411**	**792,238,209**
OPERATING EXPENSES		
Instruction and departmental research	406,523,993	396,841,703
Research	213,737,149	201,077,342
Public services	157,929,129	155,778,736
Academic support	57,751,054	60,326,358
Student services	24,793,786	24,530,479
Scholarships and fellowships	23,702,517	24,041,329
Institutional support	59,059,640	56,077,542
Operation and maintenance of plant	86,595,745	82,790,956
Auxiliary enterprises	185,646,346	169,432,294
Depreciation	69,501,144	60,589,129
Other expenses	8,137,658	9,986,072
TOTAL OPERATING EXPENSES	**1,293,378,161**	**1,241,471,940**
Operating loss	(421,192,750)	(449,233,731)
NONOPERATING REVENUES (EXPENSES)		
State of Michigan appropriations	380,802,125	394,613,600
Gifts	38,665,666	29,854,418
Net investment income	61,612,679	41,954,862
Interest expense on capital asset related debt	(5,937,247)	(6,658,900)
Other revenues	1,959,862	758,072
Net nonoperating revenues before capital and endowment additions	477,103,085	460,522,052
State capital appropriations	-	12,317,246
Capital grants and gifts	6,780,338	6,321,904
Additions to permanent endowments	14,244,290	23,642,976
NET NONOPERATING REVENUES	**498,127,713**	**502,804,178**
Increase in net assets	76,934,963	53,570,447
Net assets, beginning of year	1,640,937,094	1,587,366,647
NET ASSETS, END OF YEAR	**$ 1,717,872,057**	**$ 1,640,937,094**

See accompanying notes

STATEMENTS OF CASH FLOWS
Michigan State University

	Year ended June 30, 2003	2002
Cash flows from operating activities		
Tuition and fees	$ 282,859,635	$ 255,578,268
Research grants and contracts	284,432,868	269,231,201
Auxiliary activities	209,313,807	193,353,347
Departmental activities	99,334,759	95,122,252
Interest and fees on student loans	795,291	879,538
Loans issued to students	(14,268,877)	(7,815,369)
Collection of loans from students	11,089,486	9,474,726
Scholarships and fellowships	(26,349,915)	(25,266,216)
Payments to suppliers	(291,720,042)	(290,886,737)
Payments to employees	(888,756,358)	(848,781,548)
Other receipts (payments)	(5,232,057)	654,193
Net cash used by operating activities	(338,501,403)	(348,456,345)
Cash flows from noncapital financing activities		
State appropriations	384,747,975	393,553,056
Gifts	37,598,141	30,810,193
Endowment gifts	20,329,487	25,071,790
William D. Ford direct lending receipts	155,957,000	147,185,000
William D. Ford direct lending disbursements	(155,957,000)	(147,185,000)
Net cash provided by noncapital financing activities	442,675,603	449,435,039
Cash flows from capital and related financing activities		
Capital appropriations	4,921,634	19,119,686
Capital gifts and grants	157,087	7,281,327
Proceeds from issuance of debt and other long term obligations	66,031,358	25,539,404
Purchase of capital assets	(94,671,466)	(124,777,726)
Extinguishment of capital lease	(22,374,839)	-
Proceeds from sale of capital asset	1,959,862	758,072
Principal paid on capital debt	(3,946,495)	(3,165,000)
Interest paid	(5,522,705)	(6,015,576)
Net cash used by capital and related financing activities	(53,445,564)	(81,259,813)
Cash flows from investing activities		
Investment income, net	35,407,891	58,083,280
Proceeds from sales and maturities of investments	315,105,531	100,836,486
Purchase of investments	(396,082,519)	(216,891,559)
Net cash used by investing activities	(45,569,097)	(57,971,793)
Net increase (decrease) in cash	5,159,539	(38,252,912)
Cash, beginning of year	211,033,173	249,286,085
Cash, end of year	$ 216,192,712	$ 211,033,173

See accompanying notes

STATEMENTS OF CASH FLOWS (Continued)

Michigan State University

Reconciliation of net operating loss to net cash used by operating activities:	**Year ended June 30, 2003**	**2002**
Operating loss	$ (421,192,750)	$ (449,233,731)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation expense	69,501,144	60,589,129
Change in assets and liabilities:		
Accounts receivable	964,641	(429,746)
Student loans receivable	(3,179,391)	1,659,357
Inventories and other assets	(7,751)	4,936,023
Investments in joint ventures	818,640	(581,224)
Unamortized bond origination costs	(255,717)	22,498
Accounts payable	(870,650)	860,123
Accrued personnel costs	7,849,037	4,206,231
Payroll taxes and other payroll deductions	1,884,023	5,833,373
Deposits held for others	(609,834)	1,747,872
Deferred revenues	5,022,421	18,598,104
Accrued self-insurance liabilities	1,574,784	3,335,646
Net cash used by operating activities	$ (338,501,403)	$ (348,456,345)

See accompanying notes

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 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 the 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 2003 or 2002.

Summary of significant accounting policies:

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.

Inventories - Inventories are recorded using various methods including last in first out (LIFO) and first in first out (FIFO).

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.

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 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.

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.

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.

Bond issuance costs - Bond issuance costs are capitalized and amortized over the life of the bond issue.

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.

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.

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.

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.

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.

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.

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.

Reclassifications - Certain amounts from the 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, 2003 and 2002 were as follows:

	2003	2002
Cash	$ (7,512,000)	$ (10,691,000)
Investments	194,212,000	179,479,000
Equity in pooled cash and investments	29,493,000	42,245,000
	$ 216,193,000	$ 211,033,000

The amount reported as investments for 2003 and 2002 consisted of fixed-income instruments. Of the bank balances for cash and investments, $179,000 of the total $1,198,000 in 2003 and $200,000 of the total $1,840,000 in 2002 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 5.0% in 2003 and 6.2% in 2002.

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 AA/Aa or better, 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, 2003 and 2002. 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.

	2003 Categories			
	A	B	C	Total
U.S. Government securities	$ -	$ 150,000	$ 260,000	$ 410,000
Notes and bonds	-	-	495,000	495,000
Equities	-	-	182,446,000	182,446,000
	$ -	$ 150,000	$ 183,201,000	$ 183,351,000

	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

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 $683,233,000 and $590,081,000 as of June 30, 2003 and 2002, respectively.

The University also held miscellaneous assets of $7,276,000 and $7,448,000 at June 30, 2003 and 2002, 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. For the years ended June 30, 2003 and 2002, the total return (which includes ordinary income as well as realized and unrealized gains and losses) on investments and marketable securities were as follows:

	2003	2002
Common Investment Fund	5.0%	2.3%
Base Cash Pool	11.4%	9.8%
Other	1.0%	-4.7%

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, 2003 and 2002 is summarized as follows:

	2003	2002
State operating appropriations	$ 67,802,000	$ 71,748,000
Research and sponsored programs	32,055,000	31,919,000
Departmental activities	11,841,000	12,208,000
State capital appropriations	1,794,000	6,715,000
Interest receivable	1,249,000	2,234,000
Other	6,315,000	7,627,000
	121,056,000	132,451,000
Less allowance for doubtful accounts	7,470,000	8,048,000
Net accounts and interest receivable	$ 113,586,000	$ 124,403,000

4. Student loans receivable

Student loans receivable at June 30, 2003 and 2002 include allowances for uncollectable loans of $3,830,000 and $3,860,000 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 $155,957,000 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 in the accompanying financial statements.

5. Pledges receivable

Payments on pledges receivable at June 30, 2003, 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%.

2004	$ 12,880,000
2005	8,864,000
2006	4,834,000
2007	3,444,000
2008	1,125,000
2009 and beyond	3,132,000
Total discounted pledges receivable	34,279,000
Less allowance for uncollectible pledges	3,573,000
Net pledges receivable	$ 30,706,000

6. Long term debt and other obligations

Bonds payable for the years ended June 30, 2003 and 2002 are summarized as follows:

	2002	Borrowed	Retired	2003	Due Within One Year
General Revenue Bonds, Series 2002A	$ -	$ 53,780,000	$ -	$ 53,780,000	-
General Revenue Bonds, Series 2002B	-	11,480,000	-	11,480,000	-
General Revenue Bonds, Series 2000A-2	48,835,000	-	-	48,835,000	-
General Revenue Bonds, Series 2000A-1	61,165,000	-	1,650,000	59,515,000	-
General Revenue Bonds, Series 1998A-2	51,935,000	-	-	51,935,000	-
General Revenue Bonds, Series 1998A-1	15,625,000	-	1,940,000	13,685,000	2,030,000
General Revenue Bonds, Series 1996A	24,960,000	-	1,030,000	23,930,000	1,065,000
	$ 202,520,000	$ 65,260,000	$ 4,620,000	$ 263,160,000	$ 3,095,000

	2001	Borrowed	Retired	2002	Due Within One Year
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	1,940,000
General Revenue Bonds, Series 1996A	26,270,000	-	1,310,000	24,960,000	1,030,000
	$ 205,685,000	$ -	$ 3,165,000	$ 202,520,000	$ 2,970,000

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 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.

The Series 2002A and Series 2002B bonds may be converted to a permanent fixed rate provided certain conditions are met.

During fiscal 2003, the University entered into a swap transaction related to $53,780,000 of the Series 2002A bonds. This has the effect of creating fixed rate bonds that bear interest at 3.396% through fiscal 2033. During fiscal 2003, the University entered into a swap transaction related to $11,480,000 of the Series 2002B bonds. This has the effect of creating fixed rate bonds that bear interest at 4.654% through fiscal 2023.

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 through 2031. The Series 2000A-1 bonds may be converted to a permanent fixed rate provided certain conditions are met.

The University previously 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 4.074% 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 4.604% 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 $5,937,000 and $6,659,000 for 2003 and 2002 respectively, net of capitalized interest of $4,490,000 for 2003 and $779,000 for 2002. Scheduled fiscal year maturities of bonds payable and related interest expense are as follows:

	Principal (in thousands)	Interest
2004	$ 3,095,000	$ 11,010,000
2005	2,725,000	10,850,000
2006	6,315,000	10,631,000
2007	7,770,000	10,344,000
2008	8,170,000	10,013,000
2009-2013	39,040,000	45,003,000
2014-2018	42,720,000	36,614,000
2019-2023	52,495,000	26,373,000
2024-2028	56,405,000	14,663,000
2029-2033	44,425,000	3,477,000
	$ 263,160,000	$ 178,978,000

In addition to bonds payable, the University had long term lease obligations of $3,435,000 at June 30, 2003 and federal student loan deposits of $33,445,000 and $33,018,000 from the federal government related to various federal student loan programs for the years ended June 30, 2003 and 2002, respectively.

Restricted cash related to unspent bond proceeds of $13,013,000 and $5,868,000 at June 30, 2003 and 2002, respectively, was classified with operating cash and investments.

7. Retirement benefits

The University has a defined contribution base retirement plan administered through the 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 5.0% of their base salary or wages and the University contributes 10.0% 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 and/or a deferred compensation 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, 2003 and 2002 were as follows:

	2003	2002
University contributions	$ 50,182,000	$ 48,072,000
Employee contributions	25,091,000	24,036,000

In addition, the University has a single-employer, defined benefit plan covering approximately 1,200 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, 2003.

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 2003 and 3,700 in 2002. The University recognizes the cost of providing those benefits on a pay-as-you-go basis. Those costs totaled $19,075,000 for 2003 and $16,829,000 for 2002 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, 2003, 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 $68,337,000 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, and the Biomedical and Physical Sciences Building 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. The SBA will be obligated to sell each building to the University for one dollar, after full payment of all rentals due under the related lease.

At June 30, 2003, 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, 2003, $44,563,000 of the initial $89,458,000 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 $6,178,000 as of June 30, 2003. The discount rate used was 5.0%.

The University is also self-insured for various employee benefits which include health care 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, 2003, these general, professional, and self-insured employee benefit liabilities totaled $17,354,000. Changes in the total reported liabilities during 2003, 2002, and 2001 were as follows:

	2003	2002	2001
Balance at beginning of year	$ 15,779,000	$ 12,444,000	$ 12,395,000
Claims incurred and changes in estimates	76,859,000	62,952,000	50,494,000
Claim payments	(75,284,000)	(59,617,000)	(50,445,000)
Balance at the end of year	$ 17,354,000	$ 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, 2003, the stated value of the net assets of the Foundation totaled $263,119,000. These assets are not included in the financial statements of the University. Contributions to and payments on behalf of the University totaled $18,146,000 in 2003 and $24,664,000 in 2002.

The University is a party to multiple incorporated joint ventures, most of which are accounted for under the equity method. A joint venture with Sparrow Health System, Mid-Michigan MRI, Inc., operates a magnetic resonance imaging facility. 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 Great Lakes Cancer Institute is a joint venture with McLaren Health Care Corporation to bring cancer care and research opportunities to community-based cancer centers and physicians. The University's share in each of the foregoing joint ventures is 50%. The University has a 33% share in Radiation Oncology Alliance, a joint venture with Michigan Affiliated Healthcare System, Inc. and the University of Michigan to provide radiation oncology services. Copies of financial statements for the 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 years ended June 30, 2003 and June 30, 2002 were as follows:

	2002	Additions	Disposals	2003
Non-depreciated capital assets:				
Land	$ 19,217,000	$ -	$ -	$ 19,217,000
Construction in progress	46,552,000	(20,538,000)	-	26,014,000
Collections	4,507,000	170,000	-	4,677,000
	70,276,000	(20,368,000)	-	49,908,000
Depreciated capital assets:				
Buildings and site improvements	1,256,956,000	77,504,000	1,015,000	1,333,445,000
Equipment and other	395,603,000	39,065,000	14,032,000	420,636,000
Accumulated depreciation	(796,078,000)	(69,501,000)	(13,104,000)	(852,475,000)
	856,481,000	47,068,000	1,943,000	901,606,000
Total capital assets	$ 926,757,000	$ 26,700,000	$ 1,943,000	$ 951,514,000

	2001	Additions	Disposals	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:

	2003	2002
Restricted - nonexpendable:		
Permanent endowments	$ 240,681,000	$ 224,252,000
Restricted - expendable:		
Gifts, endowment income and sponsored programs	$ 127,421,000	$ 118,415,000
Quasi and term endowments	97,255,000	109,783,000
Capital projects	31,321,000	22,911,000
Student loans	7,067,000	6,794,000
Total	$ 263,064,000	$ 257,903,000
Unrestricted:		
Designated	$ 507,209,000	$ 446,789,000
Uncommitted	6,869,000	4,673,000
Total	$ 514,078,000	$ 451,462,000

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, these net assets 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.

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.

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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, 2003 and have issued our report thereon dated August 29, 2003. 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 basic 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 29, 2003