MICHIGAN STATE UNIVERSITY

Financial Report

June 30, 2004 and 2003

TABLE OF CONTENTS

Michigan State University

Page

MICHIGAN STATE
UNIVERSITY

This report presents the financial position and results of operations of Michigan State University ("MSU" or "the University") for the fiscal years ended June 30, 2004, and June 30, 2003. 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 have been audited by KPMG LLP, Certified Public Accountants. Their audit report appears on page 17.

Tradition and innovation intersect at Michigan State University. Since 1855, MSU has been advancing knowledge and transforming lives through teaching, research, and outreach. Some 44,500 students from every county in the state, every state in the nation, and more than 125 countries worldwide enroll at Michigan State each year in 200 programs of undergraduate and graduate study. The fall 2003 freshman class reflected another strong recruiting effort with an average high school GPA of 3.58 and an average composite ACT score of 24.5.

Despite difficult financial times which resulted in a 6.7% reduction in the budgeted 2003-04 State of Michigan appropriation and a further 5.0% mid-year Executive Order rescission, 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 recognition of the University holding its 2004-05 tuition increase to the rate of inflation, the State legislature approved a refund of 3.0% of the 5.0% mid-year Executive Order. This refund will total $8,805,000 and will be included in the University's 2004-05 State appropriation.

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, 2004, the amount raised to date exceeded $850 million.

The University's ongoing review of its infrastructure indicates a need to expend over $500 million over the next ten years to modernize and renovate aging teaching, research, housing and other support facilities, utility systems, and roads, utilizing a just-in-time maintenance strategy. Examples during the 2003-04 fiscal year include upgrades to the T.B. Simon Power Plant, and new heating, ventilating, and air conditioning systems in the Biochemistry, Chemistry and Food Science Buildings. These modernizations, efforts to improve the reliability of the University's source of power and to upgrade laboratory facilities, respectively, will serve to greatly enhance the University's research mission.

Michigan State's land-grant philosophy at its founding remains central to the University's mission today. MSU continues to offer to all qualified applicants an education that is both liberal and practical. Classroom and laboratory endeavors are measured by the impact they have in the real world. Above all, Michigan State University is still a place that seeks to make a difference – and to help others learn to make a difference as well.

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

OFFICE OF THE
VICE PRESIDENT FOR FINANCE AND OPERATIONS AND TREASURER

Fred L. Poston
Vice President

Michigan State University
420 Administration Building
East Lansing, MI
48824-1046

517/355-5014
FAX: 517/353-6772

Michigan State University holds a unique position in the state's educational system. As a respected research and teaching university, it is committed to intellectual leadership and to excellence in both developing new knowledge and conveying that knowledge to its students and to the public. And as a pioneer land-grant institution, Michigan State University strives to discover practical uses for theoretical knowledge and to speed the diffusion of information to residents of the state, the nation, and the world. In fostering both research and its application, this university will continue to be a catalyst for positive intellectual, social, and technological change.*

— Mission Statement adopted by the MSU Board of Trustees on June 24-25, 1982

A LEGACY OF EXCELLENCE AND INNOVATION

The 7-foot bronze statue of John A. Hannah was dedicated on September 17, 2004. Hannah was MSU's 12th president, serving from 1941 to 1969, a period of unprecedented growth for the university.

Michigan State University begins observing its Sesquicentennial this year, celebrating 150 years as the nation's pioneer land-grant university. It was founded in 1855 as a "grand experiment" to democratize higher education and expand its opportunities beyond elite social classes, to make public service an essential part of higher education's mandate, to find practical applications for the scientific and technological innovations from its research laboratories, and—more than anything else—to offer the citizens of Michigan new possibilities.

This anniversary is an occasion to reflect on our unique history as we celebrate our rich heritage and traditions and honor the land-grant philosophy on which they were built. But perhaps more important, it is a time for us to look ahead.

As our world has changed over the years, MSU also has changed to meet its needs.

John A. Hannah, MSU's 12th president, said in 1959: "Michigan State University has been the very embodiment of the land-grant philosophy, which couples instruction, research, and extension in the interests of the people of Michigan. The problem is not one of testing the validity of this proposition, but rather of being concerned with how this philosophy can best be implemented in a period far different from the one to which that philosophy was originally indigenous."

The Biomedical and Physical Sciences Building, the largest academic facility on the MSU campus, opened in 2002. It houses teaching and research laboratories, libraries, lecture halls, office space, and conference rooms.

And that is the task to which we apply ourselves today—to renew our connection to our land-grant heritage and mission and to shape the agenda for our future, asking ourselves: "What kind of university would we create in the land-grant tradition for the 21st century, if we had it to do all over again?"

For 150 years, Michigan State has been a leader and an innovator, a forward-looking instrument for educational and social improvement, a catalyst for economic development, a national—and now, international—model for higher education. It is our responsibility, as the nation's pioneering land-grant university, to build on that legacy and to continue offering our students, scholars, and stakeholders the kinds of opportunities and possibilities that will make a lasting difference.

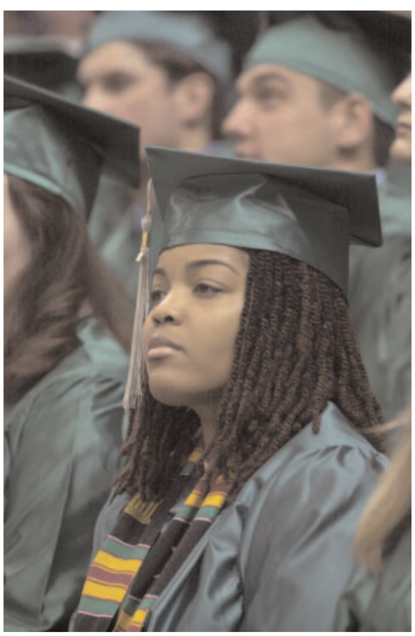
STEWARDSHIP

Michigan State University has always been a good place to invest in the future.

Students from every county in the state, every state in the nation, and more than 125 countries worldwide choose Michigan State. The current enrollment tops 44,800, with more than 16 percent of the total being students of color.

In 1855, the Michigan Legislature invested a total of $56,320 from the state treasury for all of the expenses—the land, buildings, furniture, equipment, and salaries—necessary to establish and operate the original college on a tract of farmland outside of Lansing. Today, MSU has grown to more than a billion-dollar enterprise, with connections and linkages that span the globe. And like any high-performing, globally competitive organization in the 21st century, it has obligations and expectations that must be met.

Historically, Michigan State University has been an engine of innovation for economic competitiveness and social change. We have a proven record of delivering strong results for Michigan's people and Michigan's economy.



Along with balancing the dollars and cents, we also balance expectations regarding our traditional land-grant values and our future academic quality. Our reputation is our brand, and that reputation derives from the enduring nature of our teaching, research, and outreach and from the broad range of forward-looking academic programs that define Michigan State University. That is why MSU continues to put every dollar possible toward those critical programs and initiatives. We know that every dollar we save elsewhere translates into capacity to invest in people, programs, and possibilities. And we know that those who invest in us expect a return on their investments.

RETURN ON INVESTMENT

The dividends Michigan State University pays on today's investments are embodied in the difference the institution can make for all of our tomorrows.

The commitment we make to our students—that a degree earned from Michigan State today will continue to increase in value in the future—goes hand in hand with our responsibility to contribute to society through the generation of knowledge and its application: advancing knowledge and transforming lives. According to a 2002 study, every dollar invested in Michigan's public universities returned an "education premium" of $26 to the state's economy. Few other investments offer stakeholders such an impressive rate of return.

MSU AND ECONOMIC DEVELOPMENT

Michigan State University will play a vital role in the future economic development of the state. Our mission of balancing access and economic competitiveness and promoting quality of life is an extraordinarily difficult equilibrium to maintain, even in the best of times. But our commitment to the public good—individually and collectively—is an essential characteristic of our land-grant philosophy.

MSU played a leading role during the agricultural and industrial revolutions, moving cutting-edge knowledge into practical applications that benefited both students and society, establishing Michigan as a national leader in those areas. The result was self-sustaining growth in the form of good-paying jobs, a high standard of living, and an enriched quality of life.

Today, we face a similar challenge as Michigan's manufacturing and agricultural economies transition to a knowledge-based new economy. Once again, MSU is in the vanguard, developing the research and development inputs and the technology and science workforce—the human "intellectual capital"—that will fuel Michigan's economic growth with public- and private-sector partners.

TOWARD THE FUTURE

Historically, Michigan State University has been an engine of innovation for economic competitiveness and social change. We have a proven record of delivering strong results for Michigan's people and Michigan's economy. The work done at Michigan State and the knowledge we have generated have touched lives far beyond our campus. From hybrid corn to a cyclotron, from international education to residential learning, from homogenized milk to Cisplatin, we have a long tradition of strengthening the economic and social fabric of the state, of creating and sharing knowledge that contributes to the public good.

We have been diligent and effective stewards of the public's resources, making aggressive efforts at cost containment and finding bold and innovative ways to enhance the quality of the educational experience we offer and to do more, even as we face a growing pattern of public disinvestment in public higher education over the past 30 years. We are an important asset to the state of Michigan, one that represents a significant long-term investment by the people of Michigan in both a world-class institution of higher education and in our collective future.

In 2005—our 150th year—Michigan State University remains a place of possibilities.

Introduction

The following discussion provides an overview of the financial position of Michigan State University (the "University") for the years ended June 30, 2004 and 2003 and includes an analysis of the University's Statement of Net Assets, which presents the assets, liabilities, and net assets of the institution as of the end of the fiscal year, and Statement of Revenues, Expenses, and Changes in Net Assets, which reflects revenues and expenses recognized during the fiscal year. These financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) pronouncements.

Effective July 1, 2002, the University adopted GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*. The Michigan State University Foundation (the "Foundation") is a legally separate entity which meets the criteria set forth for component units under GASB Statement No. 39. The Foundation provides financial support for the objectives, purposes, and programs of the University. Although Michigan State University does not control the timing, purpose, or amount of receipts from the Foundation, the resources (and income thereon) which the Foundation holds and invests are restricted to the activities of the University. Because these resources held by the Foundation can only be used by, or for the benefit of, the University, the Foundation is considered a component unit of the University and is discretely presented in the University's financial statements. The Foundation is a private organization that reports under Financial Accounting Standards Board (FASB) standards. As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition criteria and presentation features. No modifications have been made to the Foundation's financial information in the University's financial reporting entity for these differences.

This discussion (which excludes the Foundation) 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.

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, 2004, 2003, and 2002 follows:

	2004	2003	2002
		(in millions)	
Current assets	$ 385	$ 340	$ 358
Noncurrent assets:			
Restricted cash and investments	61	24	13
Endowment and other investments	1,026	874	764
Capital assets, net	997	952	927
Other	61	57	52
Total assets	2,530	2,247	2,114
Current liabilities	228	208	198
Noncurrent liabilities	409	321	275
Total liabilities	637	529	473
Total net assets	$ 1,893	$ 1,718	$ 1,641

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, 2004 and June 30, 2003 indicates that the University maintained 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. The net increase in 2004 includes an increase in operating cash and investments of $22 million. This increase is a function of the University's operating, financing, and investing activities as reported in the Statement of Cash Flows. The increase in current assets in 2004 also includes $12 million in student loans receivable related to the newly offered Federal Family Education Loan Program, a program under which the University serves as school as lender for graduate and professional degree students. The net decrease in current assets in 2003 primarily represents an $11 million reduction in accounts receivable as a result of decreased State of Michigan operating and capital appropriations.

Noncurrent assets:

Restricted cash and investments

Restricted cash and investments represent unspent bond proceeds which are externally restricted for the construction or purchase of capital assets. The 2004 balance is due to the University's issuance of Series 2003A and 2003C bonds in December 2003.

Endowment and other investments

At June 30, 2004 and June 30, 2003, the University's endowment investments totaled $746 million (an increase of $144 million) and $602 million (an increase of $91 million), respectively. During both 2004 and 2003, $60 million of operating cash and investments was reallocated to designated endowment investments, consistent with the

University's cash management and investment plan. Market value increases within the investment portfolio accounted for $67 million and $17 million of the increases in 2004 and 2003, respectively, while gifts to permanent endowments totaled $12 million and $14 million in 2004 and 2003, respectively.

Other investments consist primarily of the University's Operating Cash Pool's total return-oriented bond portfolio which totaled $185 million and $186 million at June 30, 2004 and 2003, respectively. Funded retirement and post-employment benefit reserves ($73 million in 2004 and $66 million in 2003) 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, 2004, 2003, and 2002, the University's investment in capital assets was as follows:

	2004	2003	2002
		(in millions)	
Land	$ 20	$ 19	$ 19
Buildings and site improvements	1,350	1,333	1,257
Construction in progress	86	26	47
Equipment and other	430	421	396
Capital assets not depreciated	5	5	4
Less: accumulated depreciation	(894)	(852)	(796)
	$ 997	$ 952	$ 927

Major additions to buildings and site improvements during 2004 included $3 million for a series of upgrades to the T.B. Simon Power Plant, and $1 million each for a series of improvements to the campus steam tunnel vaults, renovations of Jenison Field House, Engineering Building classroom alterations, and residence halls roof restorations.

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

Construction in progress reflects the commencement of multi-year projects which, once completed and placed into service, are categorized as buildings and site improvements. The 2004 balance includes $34 million for heating, ventilating, and air conditioning improvements to the Biochemistry, Chemistry, and Food Science Buildings, $13 million for Spartan Stadium suites and club seating, and $8 million for Psychology Building alterations. The 2003 balance includes $9 million for heating, ventilating, and air conditioning improvements to the Biochemistry, Chemistry, and Food Science Buildings, and $1 million each for renovations of Jenison Field House and Engineering Building classroom alterations.

As of June 30, 2004, 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 $111 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. The net increase in current liabilities in 2004 is due primarily to a $13 million increase in the current portion of long term debt and other obligations related to line of credit borrowings under the Federal Family Education Loan Program. The net increase in current liabilities in 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.

Noncurrent liabilities, primarily debt:

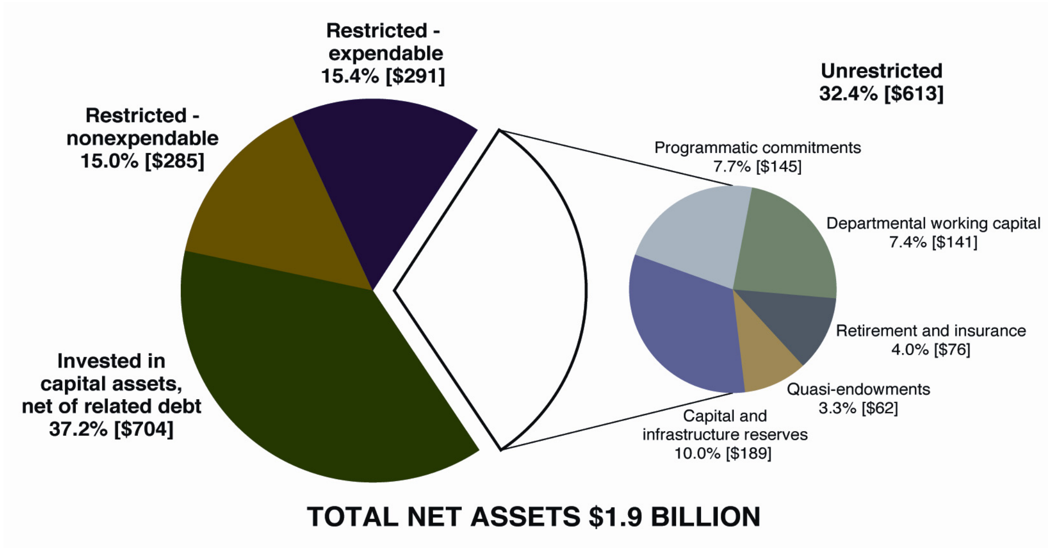
At June 30, 2004, the University had noncurrent debt and other obligations outstanding of $384 million compared with $296 million at June 30, 2003. This balance is comprised primarily of outstanding General Revenue Bonds of $348 million and $260 million in 2004 and 2003, respectively, a net increase largely due to the issuance of General Revenue Bonds Series 2003A ($80 million), 2003B ($24 million), and 2003C ($11 million) in December, 2003. The University reviews its debt capacity and related capital assets needs to optimize the use of long-term resources. The University'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, 2004, 2003, and 2002 are summarized as follows:

	2004	2003	2002
		(in millions)	
Invested in capital assets, net of related debt	$ 704	$ 700	$ 707
Restricted:			
Nonexpendable	285	241	225
Expendable	291	263	258
Total restricted	576	504	483
Unrestricted	613	514	451
Total net assets	$ 1,893	$ 1,718	$ 1,641

The following is a breakdown of net assets at June 30, 2004 (amounts are presented in millions of dollars):



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.

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 postemployment 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 $817 million as of July 2003. The University will be required to implement the provisions of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, effective with the fiscal year ending June 30, 2008. In accordance with this statement, the University will address the accounting and reporting for costs and obligations related to postemployment healthcare and other non-pension benefits.

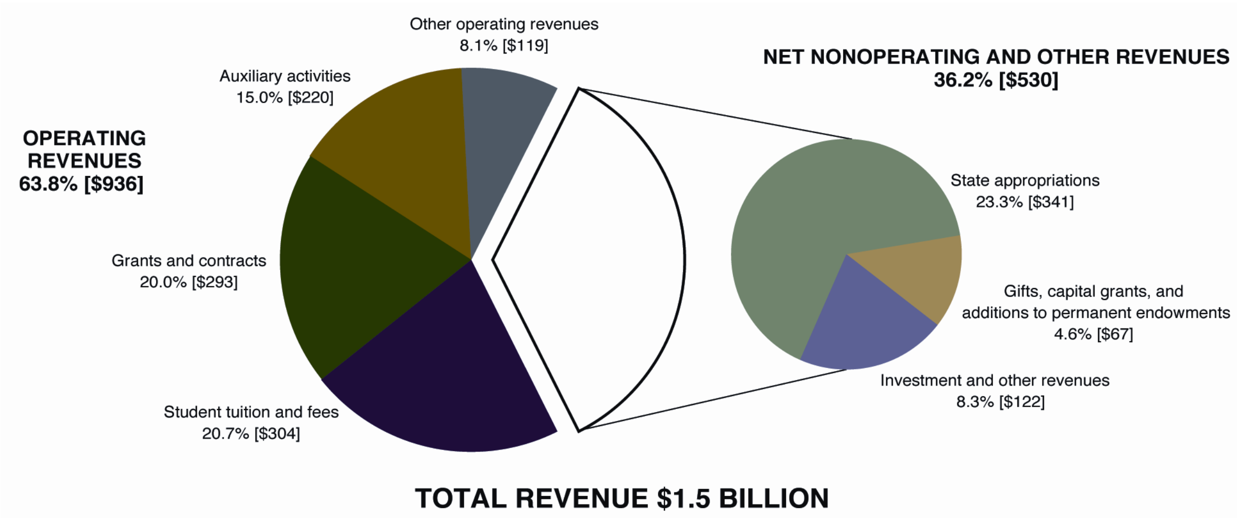
Statement of Revenues, Expenses, and Changes in Net Assets

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, 2004, 2003, and 2002 follows:

	2004	2003	2002
		(in millions)	
Operating revenues:			
Student tuition and fees, net of allowances	$ 304	$ 280	$ 254
Grants and contracts	293	284	257
Auxiliary activities	220	209	189
Other operating revenues	119	99	92
Total operating revenues	936	872	792
Operating expenses:			
Instruction and departmental research	410	406	397
Research	215	214	201
Public services	158	158	156
Academic support	60	58	60
Student services	24	25	24
Scholarships and fellowships	23	24	24
Institutional support	56	59	56
Operation and maintenance of plant	83	86	83
Auxiliary enterprises	190	185	169
Depreciation	67	70	61
Other expenses	5	8	10
Total operating expenses	1,291	1,293	1,241
Operating loss	(355)	(421)	(449)
Nonoperating revenues (expenses):			
State appropriations	341	381	395
Gifts	49	39	30
Net investment income	135	61	42
Interest expense on capital asset related debt	(12)	(6)	(7)
Other net revenues (expenses)	(1)	2	1
Net nonoperating revenues	512	477	461
Income before other revenues	157	56	12
State capital appropriations	-	-	12
Capital grants and gifts	6	7	6
Additions to permanent endowments	12	14	24
Increase in net assets	175	77	54
Net assets, beginning of year	1,718	1,641	1,587
Net assets, end of year	$ 1,893	$ 1,718	$ 1,641

The following is a graphic illustration of total revenue by source for the year ended June 30, 2004 (amounts are presented in millions of dollars):

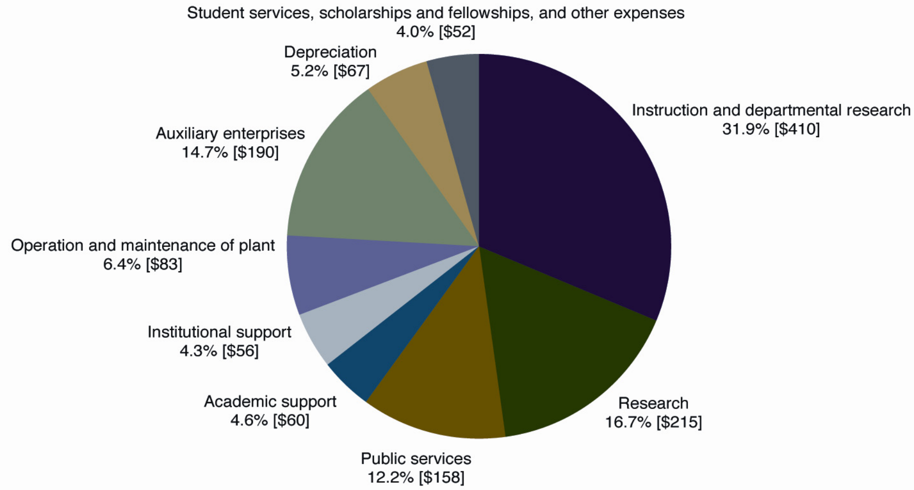


The University is supported by a diverse stream of revenue which supplements its student tuition and fees, including state appropriations, federal and state sponsored programs, private gifts and grants, and investment income. The University continues to seek funding from all possible sources consistent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

Operating revenues: The most significant source of operating revenue for the University was tuition and fees (net of scholarship allowances), totaling $304 million and $280 million at June 30, 2004 and June 30, 2003, respectively. Gross tuition and fees revenue increased 10.5% in 2004 and reflects a 10.1% effective rate increase in tuition and fees. The 10.7% increase in 2003 reflects an 8.4% rate increase in tuition and fees and a 2.3% revenue increase from additional overall student credit hours taken. Other major revenue sources in 2004 include auxiliary services of $220 million ($209 million in 2003) and federal grants and contracts of $212 million ($199 million in 2003).

Net nonoperating and other revenues: The primary source of this net revenue is state appropriations, which totaled $341 million for 2004 and $381 million for 2003. State appropriations decreased $40 million (10.5%) in 2004 via a 6.7% beginning of the year cut for the University, Michigan State University Extension, and the Michigan Agricultural Experiment Station, and an unscheduled 5.0% mid-year budget rescission for the University by the State. In 2003, appropriations decreased $14 million (3.5%) via the State's unscheduled mid-year budget rescissions. Increases in gift revenue ($10 million in 2004 and $9 million in 2003) and net investment income ($74 million in 2004 and $19 million in 2003) primarily account for the increase in net nonoperating revenues between the years.

The following is a graphic illustration of operating expenses by source for the year ended June 30, 2004 (amounts are presented in millions of dollars):



TOTAL OPERATING EXPENSES $1.3 BILLION

During 2004, $783 million (60.8%) was expended for the core missions of the University, instruction and departmental research, research, and public services, compared with $778 million (60.2%) in the prior year. Auxiliary enterprises (activities which provide services to students, faculty, staff, and the public) totaled $190 million (14.7%) and $185 million (14.3%) in 2004 and 2003, respectively.

Economic Outlook

As a result of economic pressures affecting the State of Michigan, 2004-05 fiscal year State appropriations have yet to be determined. Further, a State proposal to refund $8,805,000 in support withdrawn from the University at mid-year 2004 through an Executive Order Reduction is pending.

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, 2004, $856 million had been raised including cash, in-kind gifts, pledges, irrevocable life income agreements, and bequests.

KPMG

KPMG LLP
Suite 1200
150 West Jefferson
Detroit, MI 48226-4429

Independent Auditors' Report

The Board of Trustees
Michigan State University:

We have audited the accompanying basic financial statements of Michigan State University (the University) and its discretely presented component unit as of and for the years ended June 30, 2004 and 2003, as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the Michigan State University Foundation (the Foundation), which represent all the assets and revenues of the discretely presented component unit. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the Foundation, is based on the report of the other auditors.

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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the Foundation were not audited in accordance with *Government Auditing Standards*. 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 audit and the report of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the University and of its discretely presented component unit as of June 30, 2004 and 2003, and the respective changes in its financial position and its cash flows, where applicable, thereof 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 September 3, 2004 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 grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

As described in note 1, the University changed its reporting entity by including the Michigan State University Foundation as a discretely presented component unit, as required by the provisions of Governmental Accounting Standards Board Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, as of July 1, 2002.

The Management's Discussion and Analysis on pages 8 through 16 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

Detroit, Michigan
September 3, 2004

STATEMENTS OF NET ASSETS
Michigan State University

	June 30, 2004	June 30, 2003
ASSETS		
Current assets:		
Operating cash and investments	$ 213,491,591	$ 191,601,637
Accounts and interest receivable, net	123,163,839	113,585,644
Student loans receivable, net	22,546,037	9,392,568
Pledges receivable, net	12,664,583	11,537,276
Inventories and other assets	12,610,819	13,697,282
Total current assets	384,476,869	339,814,407
Noncurrent assets:		
Restricted cash and investments	60,848,972	24,591,075
Endowment investments	745,911,025	601,866,304
Other investments	280,265,482	271,993,848
Student loans receivable, net	29,066,001	29,589,970
Pledges receivable, net	21,985,011	19,168,765
Investments in joint ventures	6,115,300	6,125,580
Unamortized bond origination costs	4,355,956	2,117,714
Capital assets, net	996,736,021	951,513,600
Total noncurrent assets	2,145,283,768	1,906,966,856
TOTAL ASSETS	**$ 2,529,760,637**	**$ 2,246,781,263**
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts and interest payable	$ 31,275,609	$ 30,203,418
Accrued personnel costs	47,681,177	45,234,580
Accrued self-insurance liabilities	12,004,650	11,353,405
Payroll taxes and other payroll deductions	30,727,264	29,334,128
Deposits held for others	25,773,880	23,441,018
Deferred revenues	63,738,229	64,978,300
Current portion of long term debt and other obligations	16,779,085	3,770,656
Total current liabilities	227,979,894	208,315,505
Noncurrent liabilities:		
Accrued personnel costs	17,368,620	18,322,631
Accrued self-insurance liabilities	6,753,644	6,000,862
Long term debt and other obligations	384,378,880	296,270,208
Total noncurrent liabilities	408,501,144	320,593,701
Total liabilities	**636,481,038**	**528,909,206**
Net assets:		
Invested in capital assets, net of related debt	704,504,304	700,048,848
Restricted:		
Nonexpendable	284,917,207	240,681,394
Expendable	291,173,959	263,063,496
Unrestricted	612,684,129	514,078,319
Total net assets	**1,893,279,599**	**1,717,872,057**
TOTAL LIABILITIES AND NET ASSETS	**$ 2,529,760,637**	**$ 2,246,781,263**

See accompanying notes

STATEMENTS OF FINANCIAL POSITION

Michigan State University Foundation

	June 30, 2004	June 30, 2003
ASSETS		
Cash equivalents	$ 19,431,574	$ 10,928,627
Interest and dividends receivable	218,964	76,130
Assigned royalties receivable	8,279,994	6,442,485
Other receivables	473,712	343,765
Investments:		
Marketable securities	216,163,906	186,251,561
Investments in limited partnerships	47,950,938	45,826,300
Venture capital	14,757,836	12,954,789
Cash value of life insurance	1,504,959	1,525,502
Land held for investment	2,437,333	2,119,333
Other investments	621,033	644,856
Investment in IP Ventures LLC	10,232	599,703
Investment in research park	3,340,780	3,333,633
Prepaid expenses	48,456	48,904
Furniture and equipment, net	7,526	9,777
TOTAL ASSETS	**$ 315,247,243**	**$ 271,105,365**
LIABILITIES AND NET ASSETS		
Liabilities:		
Accounts payable	$ 623,617	$ 873,047
Accrued expenses and other payables	554,902	493,482
Note payable	12,000,000	-
Trusts and annuities payable	6,079,107	5,997,097
Deferred gifts	433,000	433,000
Obligations under life estate agreements	149,668	189,685
Total liabilities	**19,840,294**	**7,986,311**
Net assets:		
Unrestricted	269,250,992	239,383,966
Temporarily restricted	14,665,032	12,756,535
Permanently restricted	11,490,925	10,978,553
Total net assets	**295,406,949**	**263,119,054**
TOTAL LIABILITIES AND NET ASSETS	**$ 315,247,243**	**$ 271,105,365**

See accompanying notes

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

	Year ended June 30, 2004	Year ended June 30, 2003
OPERATING REVENUES		
Student tuition and fees	$ 351,365,838	$ 317,842,043
Less: scholarship allowances	47,115,892	37,446,679
Net student tuition and fees	304,249,946	280,395,364
State of Michigan grants and contracts	30,937,782	34,240,493
Federal grants and contracts	211,727,368	199,097,607
Local and private sponsored programs	50,566,439	50,556,490
Interest and fees on student loans	1,372,112	795,291
Departmental activities (net of scholarship allowances of $2,687,000 in 2004 and $2,352,000 in 2003)	117,145,501	98,160,162
Auxiliary activities (net of room and board allowances of $7,624,000 in 2004 and $6,590,000 in 2003)	219,922,507	208,940,004
TOTAL OPERATING REVENUES	**935,921,655**	**872,185,411**
OPERATING EXPENSES		
Instruction and departmental research	409,983,638	406,523,993
Research	214,527,625	213,737,149
Public services	158,218,848	157,929,129
Academic support	59,490,089	57,751,054
Student services	24,212,055	24,793,786
Scholarships and fellowships	23,248,991	23,702,517
Institutional support	55,941,264	59,059,640
Operation and maintenance of plant	83,188,776	86,595,745
Auxiliary enterprises	190,147,142	185,646,346
Depreciation	67,375,536	69,501,144
Other expenses	4,840,436	8,137,658
TOTAL OPERATING EXPENSES	**1,291,174,400**	**1,293,378,161**
Operating loss	(355,252,745)	(421,192,750)
NONOPERATING REVENUES (EXPENSES)		
State of Michigan appropriations	341,379,588	380,802,125
Gifts	48,562,320	38,665,666
Net investment income	135,031,446	61,612,679
Interest expense on capital asset related debt	(11,901,234)	(5,937,247)
Other revenues (expenses)	(1,268,788)	1,959,862
Net nonoperating revenues	511,803,332	477,103,085
INCOME BEFORE OTHER REVENUES	**156,550,587**	**55,910,335**
Capital grants and gifts	6,779,982	6,780,338
Additions to permanent endowments	12,076,973	14,244,290
Increase in net assets	175,407,542	76,934,963
Net assets, beginning of year	1,717,872,057	1,640,937,094
NET ASSETS, END OF YEAR	**$ 1,893,279,599**	**$ 1,717,872,057**

See accompanying notes

STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS

Michigan State University Foundation

	Year ended June 30,							
	2004				2003			
	Unrestricted Funds	Temporarily Restricted	Permanently Restricted	Total	Unrestricted Funds	Temporarily Restricted	Permanently Restricted	Total
REVENUE, GAINS AND OTHER SUPPORT:								
Contributions	$ 48,315	$ 4,289,851	$ 8,628	$ 4,346,794	$ 50,379	$ 4,245,137	$ 16,043	$ 4,311,559
Equity earnings (loss) - subsidiaries	(446,189)			(446,189)	130,712			130,712
Income from investments	5,019,287	(105,610)	284,333	5,198,010	2,336,771	86,859	446,636	2,870,266
Royalty income	20,763,437			20,763,437	4,560,541			4,560,541
Realized gain (loss) on sale of securities	(302,775)	13,878	112,167	(176,730)	(1,884,628)	7,347	(71,055)	(1,948,336)
Unrealized gain (loss) on securities	21,887,327	1,265,635	560,223	23,713,185	(3,477,197)	(145,423)	31,821	(3,590,799)
Net assets released from restrictions:								
Satisfaction of program restrictions	42,533	(26,280)	(16,253)		62,146	(48,402)	(13,744)	
Current year transfers	3,965,703	(3,528,977)	(436,726)		3,797,590	(3,302,420)	(495,170)	
TOTAL REVENUE, GAINS AND OTHER SUPPORT	50,977,638	1,908,497	512,372	53,398,507	5,576,314	843,098	(85,469)	6,333,943
EXPENSES:								
Contributions to the University	18,026,563			18,026,563	18,145,771			18,145,771
Patent expense	943,206			943,206	892,789			892,789
Investment management fees	979,250			979,250	1,358,242			1,358,242
Unrelated business tax					(362,101)			(362,101)
Management and general	1,039,916			1,039,916	845,429			845,429
Postemployment retirement benefits	59,000			59,000	59,000			59,000
Promotional expenses - Management Company	62,677			62,677	51,271			51,271
TOTAL EXPENSES	21,110,612			21,110,612	20,990,401			20,990,401
Increase (decrease) in net assets	29,867,026	1,908,497	512,372	32,287,895	(15,414,087)	843,098	(85,469)	(14,656,458)
Net assets, beginning of year	239,383,966	12,756,535	10,978,553	263,119,054	254,798,053	11,913,437	11,064,022	277,775,512
NET ASSETS, END OF YEAR	$ 269,250,992	$ 14,665,032	$ 11,490,925	$ 295,406,949	$ 239,383,966	$ 12,756,535	$ 10,978,553	$ 263,119,054

See accompanying notes

STATEMENTS OF CASH FLOWS
Michigan State University

	Year ended June 30, 2004	2003
Cash flows from operating activities		
Tuition and fees	$ 305,283,429	$ 282,859,635
Research grants and contracts	283,609,754	284,432,868
Auxiliary activities	211,291,473	209,313,807
Departmental activities	112,995,102	99,334,759
Interest and fees on student loans	1,372,112	795,291
Loans issued to students	(82,134,368)	(14,268,877)
Collection of loans from students	69,504,868	11,089,486
Scholarships and fellowships	(26,464,849)	(26,349,915)
Payments to suppliers	(276,097,470)	(291,720,042)
Payments to employees	(902,724,504)	(888,756,358)
Other receipts (payments)	(12,508,921)	(5,232,057)
Net cash used by operating activities	(315,873,374)	(338,501,403)
Cash flows from noncapital financing activities		
State appropriations	348,275,898	384,747,975
Gifts	39,723,420	37,598,141
Endowment gifts	12,275,737	20,329,487
Federal loan program receipts	1,043,348	155,957,000
Federal loan program disbursements	(1,043,348)	(155,957,000)
Federal Family Education Loan Program receipts	173,434,916	-
Federal Family Education Loan Program disbursements	(159,928,880)	-
Net cash provided by noncapital financing activities	413,781,091	442,675,603
Cash flows from capital and related financing activities		
Capital appropriations	465,272	4,921,634
Capital gifts and grants	11,476,565	157,087
Proceeds from issuance of debt and other long term obligations	115,115,000	66,031,358
Purchase of capital assets	(110,897,692)	(94,671,466)
Extinguishment of capital lease	-	(22,374,839)
Proceeds from sale of capital assets	164,953	657,525
Principal paid on capital debt	(27,503,935)	(3,946,495)
Interest paid	(9,458,831)	(5,522,705)
Other receipts (payments)	(1,433,741)	1,302,337
Net cash used by capital and related financing activities	(22,072,409)	(53,445,564)
Cash flows from investing activities		
Investment income, net	68,446,424	35,407,891
Proceeds from sales and maturities of investments	1,737,853,847	315,105,531
Purchase of investments	(1,823,987,728)	(396,082,519)
Net cash used by investing activities	(17,687,457)	(45,569,097)
Net increase in cash	58,147,851	5,159,539
Cash, beginning of year	216,192,712	211,033,173
Cash, end of year	$ 274,340,563	$ 216,192,712

See accompanying notes

STATEMENTS OF CASH FLOWS (Continued)

Michigan State University

	Year ended June 30,	
Reconciliation of net operating loss to net cash used by operating activities:	**2004**	**2003**
Operating loss	$ (355,252,745)	$ (421,192,750)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation expense	67,375,536	69,501,144
Change in assets and liabilities:		
Accounts receivable	(16,316,847)	964,641
Student loans receivable	(12,629,500)	(3,179,391)
Inventories and other assets	1,086,463	(7,751)
Investments in joint ventures	10,280	818,640
Unamortized bond origination costs	(2,238,242)	(255,717)
Accounts payable	(3,290,859)	(870,650)
Accrued personnel costs	1,492,586	7,849,037
Payroll taxes and other payroll deductions	1,393,136	1,884,023
Deposits held for others	2,332,862	(609,834)
Deferred revenues	(1,240,071)	5,022,421
Accrued self-insurance liabilities	1,404,027	1,574,784
Net cash used by operating activities	$ (315,873,374)	$ (338,501,403)

1. Organization, basis of presentation, reporting entity, 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. The University has grown into a comprehensive research university providing undergraduate, graduate, and professional degree programs. The University is not a component unit of the State of Michigan 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 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, research, and outreach programs and initiatives, postemployment benefits, and capital asset renewals and replacements.

Reporting entity:

Effective July 1, 2002, the University adopted GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*. The Michigan State University Foundation (the "Foundation") is a legally separate, tax-exempt entity which meets the criteria set forth for component units under GASB Statement No. 39. The Foundation provides financial support for the objectives, purposes, and programs of the University. Although the University does not control the timing, purpose, or amount of receipts from the Foundation, the resources (and income thereon) which the Foundation holds and invests are restricted to the activities of the University. Because the resources held by the Foundation can only be used by, or for the benefit of, the University, the Foundation is considered a component unit of the University and its Statements of Financial Position and Statements of Activities and Changes in Net Assets are separately presented in the University's financial statements. In addition, the Foundation's significant notes are summarized in Footnote 3.

The Foundation is a private organization that reports under FASB standards, including FASB Statement No. 117, *Financial Reporting for Not-for-Profit Organizations*. As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition criteria and presentation features. No modifications have been made to the Foundation's financial information in the University's financial reporting entity for these differences.

Complete financial statements for the Foundation can be obtained by a written request to: Michigan State University Foundation, 4700 South Hagadorn Road, East Lansing, Michigan 48823.

Summary of significant accounting policies:

Pledges – Financial support in the form of pledges is received from business enterprises, foundations and individuals. Revenue from 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 assets until actually 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, or public service. These collections are neither disposed of for financial gain nor encumbered in any way. 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 death, retirement, or termination. 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 – Operating activities as reported on the Statement of Revenues, Expenses, and Changes in Net Assets are those activities that generally result from exchange transactions, such as payments received for providing services and payments made for services or goods received. Nearly all of the University's expenses are from exchange transactions. Certain significant revenue streams relied upon for operations are recorded as nonoperating revenues, as defined by GASB Statement No. 34, including state appropriations, gifts, and investment income. Restricted and unrestricted resources are spent and tracked at the discretion of the recipient 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 represent 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 over such expenses.

Auxiliary activities – Auxiliary activities primarily 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 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 – 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 and restricted 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 a part of the State of Michigan for purposes of Internal Revenue Code Section 115, and is an organization described in Internal Revenue Code Section 501(c)(3). The University's income generally is exempt from federal income taxes, although income from certain activities may be subject to taxation as unrelated business income.

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

2. Cash and investments, Endowment and Other investments

Cash and investments: Operating and Restricted – The University uses the "pooled cash" method of accounting for substantially all of its cash and investments, which as of June 30, 2004 and 2003 were as follows:

	2004	2003
Cash	$ (12,628,000)	$ (7,512,000)
Investments	253,314,000	194,212,000
Equity in pooled cash and investments	33,655,000	29,493,000
	$ 274,341,000	$ 216,193,000

The amount reported as investments for 2004 and 2003 consisted of fixed-income instruments. Of the bank balances for cash and investments, $100,000 of the total $808,000 in 2004 and $179,000 of the total $1,198,000 in 2003 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 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 managers. All securities are purchased to maintain a minimum average portfolio quality rating of A.

The total return (which includes ordinary income as well as realized and unrealized gains and losses) on cash and investments was 0.3% in 2004 and 5.0% in 2003.

Restricted cash and investments represent unspent bond proceeds of $60,849,000 and $24,591,000 at June 30, 2004 and 2003, respectively, which are externally restricted for the construction or purchase of capital assets.

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, 2004 and 2003. 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.

	2004 Categories			
	A	B	C	Total
U.S. Government securities	$ -	$ 90,000	$ 87,389,000	$ 87,479,000
Notes and bonds	-	-	38,415,000	38,415,000
Equities	-	-	251,324,000	251,324,000
	$ -	$ 90,000	$ 377,128,000	$ 377,218,000

	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

In addition to the above, the University has pooled investments held by several trust companies that are managed by independent investment managers. These investments totaled $640,347,000 and $683,233,000 as of June 30, 2004 and 2003, respectively.

The University also held miscellaneous assets of $8,611,000 and $7,276,000 at June 30, 2004 and 2003, 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, 2004 and 2003, the total return on investments and marketable securities were as follows:

	2004	2003
Common Investment Fund	18.7%	5.0%
Base Cash Pool	0.8%	11.4%
Other	7.8%	1.0%

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. Foundation investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the Statements of Financial Position. The Foundation has entered into various limited partnerships and managed accounts with investment managers. These investments are secured by the underlying value of the securities composing the portfolios.

Foundation investments at June 30, 2004 and 2003 are summarized as follows:

	2004		2003	
	Cost	Market	Cost	Market
Short-term investments	$ 1,053,000	$ 1,053,000	$ 29,778,000	$ 29,779,000
Domestic equities	39,850,000	41,382,000	45,437,000	46,454,000
Foreign equities	47,959,000	44,077,000	57,472,000	40,523,000
Other equities	5,360,000	5,726,000	7,439,000	8,952,000
Fixed income	60,489,000	59,963,000	-	-
Mutual funds – Equities	46,969,000	49,454,000	53,624,000	46,142,000
Mutual funds – Fixed	14,331,000	14,509,000	13,816,000	14,402,000
Limited partnerships	41,432,000	47,951,000	40,658,000	45,826,000
	$ 257,443,000	$ 264,115,000	$ 248,224,000	$ 232,078,000

Marketable securities: The fair values for marketable debt and equity securities are based on quoted market prices. Securities traded on national securities exchanges are valued at the reported sales price on the last business day of the year. Investments traded over the counter on the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices.

Limited partnership investments: The carrying amount reported is stated at fair market value.

4. Accounts and interest receivable

The composition of accounts and interest receivable at June 30, 2004 and 2003 is summarized as follows:

	2004	2003
State operating appropriations	$ 60,906,000	$ 67,802,000
Research and sponsored programs	42,240,000	32,055,000
Departmental activities	15,882,000	11,841,000
Interest receivable	1,872,000	1,249,000
Other	9,614,000	8,109,000
	130,514,000	121,056,000
Less: allowance for doubtful accounts	7,350,000	7,470,000
Net accounts and interest receivable	$ 123,164,000	$ 113,586,000

5. Student loans receivable

Student loans receivable at June 30, 2004 and 2003 include allowances for uncollectible loans of $3,895,000 and $3,882,000, respectively. Principal repayment and interest rate terms of federal and University loans vary considerably. Campus-based federal loan programs are funded principally with federal contributions to the University under the Perkins and various health professions loan programs. Effective July 1, 2003, the University serves as school as lender for graduate and professional degree student loans under the U.S. Department of Education Federal Family Education Loan Program. For the year ended June 30, 2004, the University distributed $64,793,000 in loans under this program. To facilitate the distribution of the loans, the University obtained a line of credit (see Footnote 7).

For the year ended June 30, 2004, the University distributed $108,642,000 for undergraduate student loans through the U.S. Department of Education Federal Family Education Loan Program. These distributions and related funding sources are not included as expenses and revenues in the accompanying financial statements.

6. Pledges receivable

Payments on pledges receivable at June 30, 2004, expected to be received in the following fiscal years ended June 30, are summarized below. The allowance for uncollectible pledges receivable is made based on prior collection experience and management judgment. 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%.

2005	$ 14,152,000
2006	7,355,000
2007	5,716,000
2008	3,884,000
2009	3,207,000
2010 and beyond	4,380,000
Total discounted pledges receivable	38,694,000
Less: allowance for uncollectible pledges	4,044,000
Net pledges receivable	$ 34,650,000

7. Long term debt and other obligations

Long term debt and other obligations for the years ended June 30, 2004 and 2003 are summarized as follows:

	2003	Borrowed	Retired	2004	Current Portion
General Revenue Bonds:					
Series 2003A	$ -	$ 80,570,000	$ -	$ 80,570,000	$ -
Series 2003B	-	23,695,000	-	23,695,000	155,000
Series 2003C	-	10,850,000	-	10,850,000	-
Series 2002A	53,780,000	-	-	53,780,000	-
Series 2002B	11,480,000	-	-	11,480,000	-
Series 2000A-2	48,835,000	-	-	48,835,000	-
Series 2000A-1	59,515,000	-	2,400,000	57,115,000	-
Series 1998A-2	51,935,000	-	-	51,935,000	-
Series 1998A-1	13,685,000	-	2,030,000	11,655,000	2,130,000
Series 1996A	23,930,000	-	22,710,000	1,220,000	595,000
	263,160,000	115,115,000	27,140,000	351,135,000	2,880,000
Federal student loan deposits	33,445,000	523,000	360,000	33,608,000	-
Short term line of credit	-	64,793,000	51,287,000	13,506,000	13,506,000
Notes payable	3,436,000	-	527,000	2,909,000	393,000
	$ 300,041,000	$ 180,431,000	$ 79,314,000	$ 401,158,000	$ 16,779,000

	2002	Borrowed	Retired	2003	Current Portion
General Revenue Bonds:					
Series 2002A	$ -	$ 53,780,000	$ -	$ 53,780,000	$ -
Series 2002B	-	11,480,000	-	11,480,000	-
Series 2000A-2	48,835,000	-	-	48,835,000	-
Series 2000A-1	61,165,000	-	1,650,000	59,515,000	-
Series 1998A-2	51,935,000	-	-	51,935,000	-
Series 1998A-1	15,625,000	-	1,940,000	13,685,000	2,030,000
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
Federal student loan deposits	33,018,000	624,000	197,000	33,445,000	-
Notes payable	24,793,000	-	21,357,000	3,436,000	676,000
	$ 260,331,000	$ 65,884,000	$ 26,174,000	$ 300,041,000	$ 3,771,000

All bonds are secured by General Revenues and certain issues bear interest based on a weekly rate determined by the remarketing agent and are amortized through mandatory redemptions as follows:

- Series 2003A, Series 2003C, Series 2002A: from fiscal 2006 through 2033
- Series 2003B: from fiscal 2005 through 2026
- Series 2002B: from fiscal 2006 through 2023
- Series 2000A-2: from fiscal 2007 through 2031
- Series 2000A-1: from fiscal 2006 through 2031
- Series 1998A-2: from fiscal 2010 through 2023

The foregoing bonds may be converted to a permanent fixed rate provided certain conditions are met.

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

The Series 1996A bonds bear interest at rates varying from 4.55% to 4.65% and mature serially through fiscal 2006 (see Footnote 16).

Interest expense was $11,901,000 and $5,937,000 for 2004 and 2003, respectively, net of capitalized interest of $911,000 for 2004 and $4,490,000 for 2003.

Swap payments and associated debt: Using rates as of June 30, 2004, scheduled fiscal year maturities of bonds payable and related interest expense are as follows. As rates vary, variable-rate interest payments and net swap payments will vary (see Footnote 17):

Fiscal Year	Fixed-Rate Bonds		Variable-Rate Bonds		Interest Rate	
Ending June 30,	Principal	Interest	Principal	Interest	Swaps, Net	Total
2005	$ 2,725,000	$ 548,000	$ 155,000	$ 3,469,000	$ 10,253,000	$ 17,150,000
2006	2,845,000	428,000	5,545,000	3,437,000	10,211,000	22,466,000
2007	2,320,000	300,000	7,535,000	3,366,000	10,041,000	23,562,000
2008	2,430,000	189,000	7,895,000	3,283,000	9,827,000	23,624,000
2009	2,555,000	64,000	8,145,000	3,197,000	9,605,000	23,566,000
2010-2014	-	-	50,650,000	14,431,000	43,656,000	108,737,000
2015-2019	-	-	58,805,000	11,644,000	35,524,000	105,973,000
2020-2024	-	-	70,455,000	8,277,000	25,561,000	104,293,000
2025-2029	-	-	74,510,000	4,536,000	14,403,000	93,449,000
2030-2033	-	-	54,565,000	1,003,000	3,441,000	59,009,000
Total	$ 12,875,000	$ 1,529,000	$ 338,260,000	$ 56,643,000	$ 172,522,000	$ 581,829,000

Federal student loan deposits represent funds from the federal government related to various federal student loan programs.

At June 30, 2004, the University owed $13,506,000 on a short term $75,000,000 line of credit related to the University's distribution of graduate and professional degree student loans under the Federal Family Education Loan Program (see Footnote 5). Principal amounts outstanding under this line of credit bear interest equal to sixty basis points over the London Interbank Offering Rate (LIBOR), and accrued interest is payable monthly. Payment terms of the principal balance outstanding at June 30, 2004 vary, but do not exceed six months.

The University had long term lease obligations of $2,908,000 at June 30, 2004.

Accrued personnel costs include vacation and sick leave days earned but unused, including the University's share of payroll taxes, valued at the current rate of pay. Changes in the balances of accrued personnel costs during 2004 and 2003 were as follows:

	2004	2003
Balance, beginning of year	$ 63,557,000	$ 55,708,000
Additions	3,157,000	10,178,000
Reductions	(1,664,000)	(2,329,000)
Balance, end of year	65,050,000	63,557,000
Less: current portion	47,681,000	45,235,000
Noncurrent portion	$ 17,369,000	$ 18,322,000

8. 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, 2004 and 2003 were as follows:

	2004	2003
University contributions	$ 50,892,000	$ 50,182,000
Employee contributions	25,446,000	25,091,000

In addition, the University has a single-employer, defined benefit plan covering approximately 1,100 employees hired prior to January 1, 1973. The plan is closed to new entrants and monies have been internally reserved by the University to fully fund program costs. 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, 2004.

9. 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 3,800 in 2004 and 3,700 in 2003. The University recognizes the cost of providing those benefits on a pay-as-you-go basis. Those costs totaled $20,004,000 for 2004 and $19,075,000 for 2003 and are included in operating expenses in the Statement of Revenues, Expenses, and Changes in Net Assets (see Footnote 18).

10. 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 adjustments of costs, if any, resulting from such examination by the granting agency would be insignificant.

11. Commitments

At June 30, 2004, 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 $111,260,000 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 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 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, 2004, the University had entered into various limited partnerships with investment managers of oil and gas, real estate, venture capital, private equity, and restructuring funds. As of June 30, 2004, $47,538,000 of the initial $100,050,000 investment commitment remains outstanding.

12. 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 $6,778,000 as of June 30, 2004. 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 the 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, 2004, these general, professional, and self-insured employee benefit liabilities totaled $18,758,000. Changes in the total reported liabilities during 2004, 2003, and 2002 were as follows:

	2004	2003	2002
Balance, beginning of year	$ 17,354,000	$ 15,779,000	$ 12,444,000
Claims incurred and changes in estimates	82,719,000	76,859,000	62,952,000
Claim payments	(81,315,000)	(75,284,000)	(59,617,000)
Balance, end of year	18,758,000	17,354,000	15,779,000
Less: current portion	12,005,000	11,353,000	10,372,000
Noncurrent portion	$ 6,753,000	$ 6,001,000	$ 5,407,000

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.

13. Investments in joint ventures

The University is a member of several incorporated not for profit joint ventures, most of which are accounted for under the equity method. The University and Sparrow Health System are members of Mid-Michigan MRI, Inc., which operates a magnetic resonance imaging facility. University Rehabilitation Alliance, Inc. has the University and Peckham Vocational Industries of Lansing as members and is an enterprise for the treatment of persons with brain injury. The Great Lakes Cancer Institute is a corporation formed with McLaren Health Care Corporation to bring cancer care and research opportunities to community-based cancer centers and physicians. The University is a 50% member in each of the foregoing not for profit corporations. Additionally, the University is a 33% member in Radiation Oncology Alliance, a not for profit corporation formed with Michigan Affiliated Healthcare System, Inc. and the University of Michigan to provide radiation oncology services. Copies of financial statements for these entities 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.

14. Capital assets and collections

Capital asset and collection activity for the years ended June 30, 2004 and 2003 follows:

	2003	Additions (Deductions)	Disposals	2004
Non-depreciated capital assets:				
Land	$ 19,217,000	$ 300,000	$ -	$ 19,517,000
Construction in progress	26,014,000	59,925,000	-	85,939,000
Collections	4,677,000	461,000	-	5,138,000
	49,908,000	60,686,000	-	110,594,000
Depreciated capital assets:				
Buildings and site improvements	1,333,445,000	16,549,000	-	1,349,994,000
Equipment and other	420,636,000	38,025,000	28,497,000	430,164,000
Less: accumulated depreciation				
Buildings and site improvements	(539,994,000)	(33,894,000)	-	(573,888,000)
Equipment and other	(312,481,000)	(33,481,000)	(25,834,000)	(320,128,000)
	901,606,000	(12,801,000)	2,663,000	886,142,000
Total capital assets	$ 951,514,000	$ 47,885,000	$ 2,663,000	$ 996,736,000

	2002	Additions (Deductions)	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:				
Building 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
Less: accumulated depreciation				
Buildings and site improvements	(507,788,000)	(32,434,000)	(228,000)	(539,994,000)
Equipment and other	(288,290,000)	(37,067,000)	(12,876,000)	(312,481,000)
	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

15. Net assets

Restricted and unrestricted net assets for the years ended June 30, 2004 and 2003 follows:

	2004	2003
Restricted - nonexpendable:		
Permanent endowments	$ 284,917,000	$ 240,681,000
Restricted - expendable:		
Gifts, endowment income and sponsored programs	$ 148,927,000	$ 127,421,000
Quasi and term endowments	112,088,000	97,255,000
Capital projects	22,946,000	31,321,000
Student loans	7,213,000	7,067,000
Total	$ 291,174,000	$ 263,064,000
Unrestricted:		
Designated	$ 616,547,000	$ 507,209,000
Uncommitted	(3,863,000)	6,869,000
Total	$ 612,684,000	$ 514,078,000

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.

16. Defeasance of debt

During the year ended June 30, 2004, the University used $23,563,000 of the Series 2003B bonds to defease in substance $21,645,000 of callable Series 1996A bonds by depositing U.S. Government securities in an irrevocable trust with an escrow agent to provide for future debt service payments of those bonds. The related assets and liabilities are not included in the financial statements of the University. The undiscounted cash flow to service the new debt decreased $2,032,000. The economic gain resulting from this transaction amounted to $1,513,000. As of June 30, 2004, $21,645,000 of bond principal remains outstanding and is scheduled to be paid off during the fiscal year ending June 30, 2006.

17. Derivatives not reported at fair value

The University is party to derivative financial instruments – interest rate swaps that are intended to effectively convert variable-rate debt to fixed-rate debt – that are not reported at fair value on the Statement of Net Assets at June 30, 2004.

Objective of the swaps: In order to protect against the potential of rising interest rates, the University has entered into nine separate pay-fixed, receive-variable interest rate swaps at a cost less than what the University would have paid to issue fixed-rate debt.

Terms, fair values, and credit risk: The terms, fair values, and credit rating of the outstanding swaps as of June 30, 2004 are as follows. The notional amounts of the swaps match the principal amounts of the associated debt. The University's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to follow scheduled or anticipated reductions in the associated "bonds payable" category:

Associated Bond Issue	Notional Amount	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Values	Swap Termination Date	Counterparty/ Counterparty Credit Rating
1998A-2	$ 51,935,000	7/1/1998	4.604%	BMA Municipal Swap Index	$ (5,611,000)	8/15/2022	Ambac Financial Services/Aaa
2000A-1 & 2000A-2	98,545,000	5/2/2002	4.074%	67% USD-LIBOR-BBA	(5,298,000)	8/15/2029	Lehman Brothers Special Financing Inc./A2
2002A	51,660,000	10/17/2002	3.390%	67% USD-LIBOR-BBA	422,000	8/15/2032	UBS Warburg/Aa2
2002A	2,120,000	10/17/2002	3.530%	67% USD-LIBOR-BBA	16,000	8/15/2022	UBS Warburg/Aa2
2002B	9,440,000	10/17/2002	4.330%	USD-LIBOR-BBA	10,000	8/15/2018	UBS Warburg/Aa2
2002B	2,040,000	10/17/2002	5.280%	USD-LIBOR-BBA	20,000	8/15/2022	UBS Warburg/Aa2
2003A	80,570,000	12/11/2003	3.618%	67% USD-LIBOR-BBA	(408,000)	2/15/2033	Lehman Brothers Special Financing Inc./A2
2003B	23,695,000	12/11/2003	3.479%	67% USD-LIBOR-BBA	83,000	2/15/2026	UBS Warburg/Aa2
2003C	10,850,000	12/11/2003	5.330%	USD-LIBOR-BBA	31,000	2/15/2033	Lehman Brothers Special Financing Inc./A2

Fair Value – Primarily because interest rates have declined since the execution of certain swaps, the swaps in total have a negative fair value of $10,901,000 as of June 30, 2004. The swaps' negative fair value may be countered by a reduction in total interest payments required under the variable-rate bonds, creating a lower synthetic rate. Because the coupons on the University's variable-rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. The fair value was estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swaps, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. The payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the dates of each of the future net settlements on the swaps.

Credit Risk – Although the University executes swap transactions with various counterparties, three swaps, approximating 57 percent of the notional amount of swaps outstanding, are held with Lehman Brothers Special Financing, Inc, which is rated A2. Of the remaining swaps, the University holds five agreements with UBS Warburg, rated Aa2, making up approximately 27 percent of the outstanding notional value. The remaining swap is held with AMBAC Financial Services, rated Aaa.

As of June 30, 2004, (1) the University's credit ratings were Aa2 and AA as assigned by Moody's and Standard & Poor's, respectively, and (2) the University was exposed to $499,000 of credit risk. The following table demonstrates the thresholds and minimum transfers for collateralization:

Credit Rating	AMBAC		UBS Warburg		Lehman Brothers Special Financing, Inc. Series 2000A*		Lehman Brothers Special Financing, Inc. Series 2003A & C	
(Moody's / S&P)	Threshold	Minimum Transfer	Threshold	Minimum Transfer	Threshold	Minimum Transfer	Threshold	Minimum Transfer
Aaa/AAA	Unlimited	N/A	$ 40,000,000	$ 1,000,000	$ 1,000,000	$ 100,000	$ 40,000,000	$ 1,000,000
Aa3/AA- to Aa1/AA+	$6,000,000	$ 1,000,000	6,000,000	1,000,000	1,000,000	100,000	6,000,000	1,000,000
A3/A- to A1/A+	1,500,000	500,000	1,500,000	500,000	1,000,000	100,000	1,500,000	500,000
Above Baa2/BBB- up to Baa1/BBB+	500,000	250,000	500,000	250,000	1,000,000	100,000	500,000	250,000
Baa2/BBB	500,000	250,000	500,000	250,000	500,000	100,000	500,000	250,000
Below Baa2/BBB	-	250,000	-	250,000	-	100,000	-	250,000

*Unilateral collateralization - Lehman Brothers Special Financing, Inc. only.

Basis Risk – The swap exposes the University to basis risk should the rates resulting from the BMA swap index for the 1998A-2 swap, 67% USD-LIBOR-BBA for the 2000A-1, 2000A-2, 2002A, 2003A, and 2003B swaps, and USD-LIBOR-BBA for the 2002B and 2003C swaps not equal the rate the University pays.

Termination Risk – The University or any of the involved counterparties may terminate any of the swaps if the other party fails to perform under the terms of the contract. If the swap is terminated, the variable-rate bonds would no longer carry a synthetic fixed interest rate. Also, if at the termination the swap has a negative fair value, the University would be liable to the appropriate counterparty for a payment equal to the swap's fair value.

18. New accounting pronouncements

The University will be required to implement the provisions of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, effective with the fiscal year ending June 30, 2008. The University will be required to address the accounting and reporting for costs and obligations related to postemployment healthcare and other non-pension benefits. The University has not yet determined the full impact of GASB Statement No. 45 on its financial statements.

The University will be required to implement the provisions of GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, effective with the fiscal year ending June 30, 2006. The University will be required to address the accounting and reporting for impaired capital assets, if any, and insurance recoveries. The University has not yet determined the full impact of GASB Statement No. 42 on its financial statements.

The University will be required to implement the provisions of GASB Statement No. 40, *Deposit and Investment Risk Disclosures* effective with the fiscal year ending June 30, 2005. The University will be required to address common deposit and investment risks related to credit, interest rates, and foreign currencies. This statement also requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. The University has not yet determined the impact of GASB Statement No. 40 on its financial statements.

Financial report prepared 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.

KPMG LLP
Suite 1200
150 West Jefferson
Detroit, MI 48226-4429

Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters 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) and its discretely presented component unit as of and for the year ended June 30, 2004, and have issued our report thereon dated September 3, 2004. We did not audit the financial statements of the Michigan State University Foundation (the Foundation), which represent all the assets and revenues of the discretely presented component unit. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the Foundation, is based on the report of other auditors. As described in note 1 to the basic financial statements, as of July 1, 2002, the University adopted Governmental Accounting Standards Board Statement No. 39, *Determining Whether Certain Organizations Are Component Units*. 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. The financial statements of the Foundation were not audited in accordance with *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 opinions on the basic financial statements and not to provide an opinion 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 that might be material weaknesses. A material weakness is a reportable 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 caused by error or fraud 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.

Compliance and Other Matters

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 grant agreements, 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 or other matters that are required to be reported under *Government Auditing Standards*.

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

Detroit, Michigan
September 3, 2004