MICHIGAN STATE UNIVERSITY

Financial Report

June 30, 2005 and 2004

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Michigan State University

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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, 2005, and June 30, 2004. 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.

Since 1855, MSU has been advancing knowledge and transforming lives through teaching, research, and outreach. Some 45,000 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 2004 freshman class reflected another strong recruiting effort with an average high school GPA of 3.56 and an average composite ACT score of 24.5.

Despite continued difficult financial times, MSU made the necessary fiscal adjustments through a series of strategies with the objective of maintaining quality and balancing the budget. This was achieved by focusing on cost controls, pursuing a long-term investment strategy to maximize risk-adjusted total returns, and appropriate utilization of debt and other resources to meet programmatic needs, including the maintenance and replacement of the University's infrastructure.

In an effort to broaden its revenue base, the University continues The Campaign for MSU, a comprehensive fundraising initiative with a goal to generate $1.2 billion by 2007. As of June 30, 2005, the amount raised to date exceeded $1 billion.

The University's ongoing review of its infrastructure indicates a need to expend approximately $550 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 2005-06 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 and teaching missions.

Michigan State University observes its Sesquicentennial this year, celebrating 150 years as the nation's pioneer land-grant university. Since its founding, Michigan State University has been a leader and an innovator, a forward-thinking instrument for educational and social improvement, a catalyst for economic development, and a national - and now, international - model for higher education. It is our responsibility 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.

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

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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.

— John Hannah, MSU President 1941–1969

BUILDING ON A LEGACY OF EXCELLENCE AND INNOVATION

In 2005, Michigan State University observes its Sesquicentennial, celebrating the birth of a revolution conceived 150 years ago in Michigan. As the pioneer land-grant institution, this university spearheaded a movement that led to the development of a totally new educational tradition.

That "land-grant tradition" was not simply about the establishment of agricultural colleges, as some believe. Rather, it was a visionary idea of higher education that called for embracing practical knowledge, as well as traditional scientific and classical studies, and offering all—not just those preparing themselves for a handful of traditional professions—an equal opportunity to become citizen leaders and to shape a new, wider range of knowledge that, in turn, would help shape our rapidly growing nation.

In 1855, that idea was considered a "great experiment." In 2005, we reaffirm it and the land-grant values of quality, inclusion, and connectivity at its core—values that made this university the model for the land-grant revolution that transformed higher education across our nation and around the world. Today, we stand on the threshold of the next bold experiment: the land-grant university for the 21st century and the world.

This anniversary is not only an occasion to reflect on our unique history, but also a time to consider key questions that will shape our collective future: How can we contribute to creating a more civil society—on campus, locally, nationally, and globally? What is the best way to transform education to achieve real progress in transforming society to advance the public good? How can we nurture and challenge the inventive mind, sharpening and freeing it to meet the rigors of problem solving demanded in the 21st century?

Newly remodeled Marshall-Adams Hall is reflected in the window of nearby Eustace-Cole Hall.

As a great public research university, one of the top 100 in the world, endowed with a difference—the great land-grant spirit, the great land-grant heart—Michigan State University will answer those questions by accepting the responsibility, as the nation's pioneer land-grant university, to honor the values of our past and to draw from them the energy to innovate our future around the world, across the nation, and at home. We will build something enduring for our students, scholars, and stakeholders and continue to offer them the kinds of opportunities and possibilities that will make a lasting difference.

BOLDNESS BY DESIGN

By 2012, Michigan State University will be recognized worldwide as the leading land-grant research university, the model for "world-grant."

When people think of land-grant universities, we want them to think first of Michigan State. The example of our work in the classroom and in laboratories, both on campus and around the world, and our engagement in serving society will redefine the power and relevance of the land-grant mission for the 21st century world. And we will get there by working together, by staying focused amid the fascination of possibilities—the kaleidoscope of problems to solve and opportunities to seize—and by staying true to our strengths and values.

We have identified five imperatives—inspired by our historical strengths—that we will use to align existing initiatives, to guide decisions about investing in new priorities, and to focus our energies:

- Enhance the student experience—by continually improving the quality of academic programs and the value of an MSU degree for undergraduate and graduate students.
- Enrich community, economic, and family life—through research, outreach, engagement, entrepreneurship, innovation, and diversity.
- Expand international reach—through academic, research, and economic development initiatives and global, national, and local strategic alliances.
- Increase research opportunities—by significantly expanding research funding and involvement of graduate and undergraduate students in research and scholarship.
- Strengthen stewardship—by appreciating and nurturing the university's academic and financial assets, campus infrastructure, and people for optimal effectiveness today and tomorrow.

Through these imperatives, we will chart a course, using them to provide focus, guidelines for decision making, and milestones and measurements of progress and success toward fulfilling our strategic commitment.

An anthropology student digs into MSU's past during the summer 2005 excavation of Saints' Rest, the first dormitory on campus.

BUILDING FOR THE FUTURE

Michigan State University has come a long way since the first students arrived at a hastily cleared acre of land on which stood the three brick buildings that were the original college: College Hall, the first building in the world dedicated to the teaching of scientific agriculture; "Saints' Rest," the first dormitory in what would grow into the largest single-campus housing system in the country; and a horse barn. It was a modest beginning, but to many it was a place of opportunities and possibilities—"a place built of bricks and dreams."

While those original buildings are gone now, the promise that infused them remains. And one—Saints' Rest—continues to offer learning opportunities to the students who participated this summer in an archaeological excavation of its remaining foundations alongside the MSU Museum, where artifacts from the dig are now on display.

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

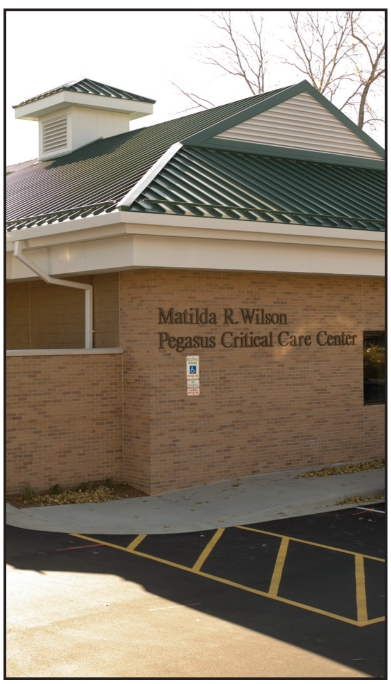
As we look around the MSU campus today—with some 2,000 acres developed or in planning and more than 660 buildings—we can see the outlines of the campus of tomorrow taking shape: the Matilda R. Wilson Pegasus Critical Care Center, a 13,000-square-foot addition to the Veterinary Clinical Center that will provide critical care for horses; the new nuclear magnetic resonance spectrometer facility at the Michigan Center for Structural Biology, brought to MSU with support from the Michigan Technology Tri-Corridor and Dow Chemical Company; the renovation and expansion of Spartan Stadium; and the relocation of the original, ceramic "Sparty" statue to the remodeled stadium and the unveiling of a new bronze "Sparty"—cast from a mold of the original—at the reconfigured and much safer intersection of Kalamazoo Street, Chestnut Road, and Red Cedar Road.

And speaking of safety, in August, Congress passed the federal highway bill with more than $16 million earmarked for the construction of underpasses at the railroad tracks that cross Farm Lane, which will allow emergency vehicles to move quickly and easily through the campus.

STEWARDSHIP

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

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 this 21st century, it has obligations and expectations that must be met.



The Matilda R. Wilson Pegasus Critical Care Center, an addition to the Veterinary Clinical Center, provides critical care for horses.

In June 2005, we surpassed the $1 billion mark in our $1.2 billion capital campaign scheduled to end in 2007. That places MSU in the elite company of only two other public universities without a teaching hospital to pass the $1 billion mark—University of California at Berkeley and Purdue. We continue to rank among the top 10 percent in our return on investment of our endowment funds. We continue to put every dollar of revenue possible into advancing opportunities for students and developing critical programs and initiatives. And, we continue to control costs because we know that every dollar we save translates into additional capacity to invest in people, programs, and new possibilities.

RETURN ON INVESTMENT

Michigan State University knows that those who invest in us expect a return on their investment. Our investors are many—the state, our students and their families, our alumni and donors, our faculty and staff, our for-profit and not-for-profit organization partners, our research-funding agencies—and all believe in MSU's ability to transform today's possibilities into opportunities for all of our tomorrows.

We make a commitment to our students and their families that a degree earned from Michigan State today will continue to increase in value in the future. We make a commitment to society that we will generate and apply knowledge to make a difference and advance the quality of life. 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

Society's expectations for its public universities continue to increase. As the pioneer land-grant institution in the world, it is in the lifeblood of Michigan State to apply the benefits of higher education to advance society and the public good. And every year we are asked to do more with less, to play an ever-greater role in building the national and local economies.

The state of Michigan explicitly recognized the vital role of higher education in the economic future and competitiveness of Michigan in the bipartisan report of The Lt. Governor's Commission on Higher Education and Economic Growth—known as the Cherry Commission—in December 2004. Research universities like Michigan State are identified as the vehicles to meet the rising demand for intellectual capital that will drive the emerging new economy in Michigan.

Michigan State already has joined forces with the cities of Lansing and East Lansing in a regional SmartZone initiative to identify commercial opportunities that will grow businesses in or attract businesses to the mid-Michigan area. The university is partnering with the Michigan Department of Labor and Economic Growth on a regional economic development process to create a permanent engine for community and economic development in the Greater Lansing area and the mid-Michigan region that will subsume the event-driven initiatives of the past into a comprehensive, proactive, sustainable force. We are just beginning to take that conversation to the larger community.

MSU will continue to be in the vanguard of Michigan's economic development efforts with our public- and private-sector partners, developing the research and development inputs and the technology and science workforce—the human "intellectual" capital—that will fuel the state's economic growth.

A bronze "Sparty," cast from the mold of the original ceramic statue, stands guard at the reconfigured intersection of Kalamazoo Street, Chestnut Road and Red Cedar Road.

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 Rwandan coffee, from international education to residential learning, from Cisplatin to Tamiflu intermediate synthesis, Michigan State has a strong reputation for addressing society's needs and providing innovations that improve lives, strengthen the economy, and contribute to the public good.

Michigan State is a diligent and effective steward of the trust and resources invested in it. At the same time, we boldly forge ahead, reinventing the land-grant university for the 21st century and the world. Although much has changed in the past 150 years, Michigan State University continues to lead and to be a place of opportunities and possibilities, still "a place built of bricks and dreams."

Introduction

The following discussion provides an overview of the financial position of Michigan State University (the "University") for the years ended June 30, 2005 and 2004 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.

The Michigan State University Foundation (the "Foundation") is a legally separate entity which meets the criteria set forth for component units under GASB regulations. 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 dedicated to benefit 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 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 services are provided and expenses and liabilities are recognized when others provide the services, 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, 2005, 2004, and 2003 follows:

	2005	2004	2003
		(in millions)	
Current assets	$ 550	$ 385	$ 340
Noncurrent assets:			
Restricted cash and cash equivalents and restricted investments	83	60	24
Endowment and other investments	1,211	1,026	874
Capital assets, net	1,080	997	952
Other	56	62	57
Total assets	2,980	2,530	2,247
Current liabilities	424	228	208
Noncurrent liabilities	486	409	321
Total liabilities	910	637	529
Total net assets	$ 2,070	$ 1,893	$ 1,718

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, 2005 and June 30, 2004 indicates that the University increased total net assets approximately 10% in each of the last two years. 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 cash and cash equivalents, securities lending collateral, investments, net accounts and interest receivable, and other assets. Effective in 2005, to enhance the return on investments, the University Board of Trustees authorized participation in a securities lending program whereby University securities are contractually loaned to approved borrowers against a pledge of collateral which is invested. As of June 30, 2005, securities lending collateral totaled $183 million and is recorded as a current asset and offsetting current liability. The net increase in current assets in 2005 is due primarily to this $183 million. The net increase in 2004 includes $12 million in student loans receivable related to the then-newly offered Federal Family Education Loan Program (the 2005 receivable balance for this program totaled $13 million).

Noncurrent assets:

Restricted cash and cash equivalents and restricted investments

These assets represent unspent bond proceeds which are externally restricted for the construction or purchase of capital assets. The 2005 balance is due to the University's issuance of Series 2005 bonds in June 2005. 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, 2005 and June 30, 2004, the University's endowment investments totaled $907 million (an increase of $161 million from the prior year) and $746 million (an increase of $144 million from the prior year), respectively. During both 2005 and 2004, $60 million of investments was reallocated to designated endowment investments, consistent with the University's Board approved cash management and investment plan. Market value (realized and unrealized) increases within the investment portfolio accounted for $77 million and $67 million of the increases in 2005 and 2004, respectively, while gifts to permanent endowments totaled $19 million and $12 million in 2005 and 2004, respectively.

Other investments consist primarily of the intermediate term fixed income securities component of the University's Operating Cash Pool which totaled $196 million and $185 million at June 30, 2005 and 2004, respectively. Funded retirement and post-employment benefit reserves ($81 million in 2005 and $73 million in 2004) substantially account for the remainder of other investments.

For the years ended June 30, 2005, 2004, and 2003, the total returns on investments were as follows:

	2005	2004	2003
Operating Cash Pool:			
Liquidity Pool	2.3%	0.3%	5.0%
Intermediate Term Fixed Income Pool	7.4%	0.8%	11.4%
Common Investment Fund	15.3%	18.7%	5.0%
Other Separately Invested Investments	5.1%	7.8%	1.0%

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, 2005, 2004, and 2003, the University's investment in capital assets was as follows:

	2005	2004 (in millions)	2003
Land	$ 20	$ 20	$ 19
Buildings and site improvements	1,432	1,350	1,333
Construction in progress	138	86	26
Equipment and other	435	430	421
Capital assets not depreciated	5	5	5
Less: accumulated depreciation	(950)	(894)	(852)
	$ 1,080	$ 997	$ 952

Major additions to buildings and site improvements during 2005 included $40 million for heating, ventilating, and air conditioning improvements to the Biochemistry, Chemistry, and Food Science Buildings, $8 million for Psychology Building alterations, and $5 million for an expansion of the T.B. Simon Power Plant.

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 hall roof restorations.

Construction in progress reflects multi-year projects which, once completed and placed into service, are categorized as buildings and site improvements. The 2005 balance includes $50 million for Spartan Stadium suites and club seating, $24 million for an expansion of the T.B. Simon Power Plant, $7 million for the Veterinary

Medical Center Oncology expansion, $6 million for Marshall-Adams Hall renovations, and $4 million for renovations to Kellogg Center guest rooms. 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.

As of June 30, 2005, 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 $79 million and are to be funded from State of Michigan and 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, securities lending collateral, deferred revenues, and other liabilities payable within one year or less. The net increase in current liabilities in 2005, as compared to 2004, is due primarily to $183 million in securities lending collateral – new in 2005. Also contributing to the net increase in current liabilities is a $16 million increase in accounts and interest payable, due primarily to completed work at Spartan Stadium ($8 million) and an expansion of the T.B. Simon Power Plant ($5 million). 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 then-new Federal Family Education Loan Program (the 2005 line of credit balance for this program totaled $14 million).

Noncurrent liabilities, primarily debt:

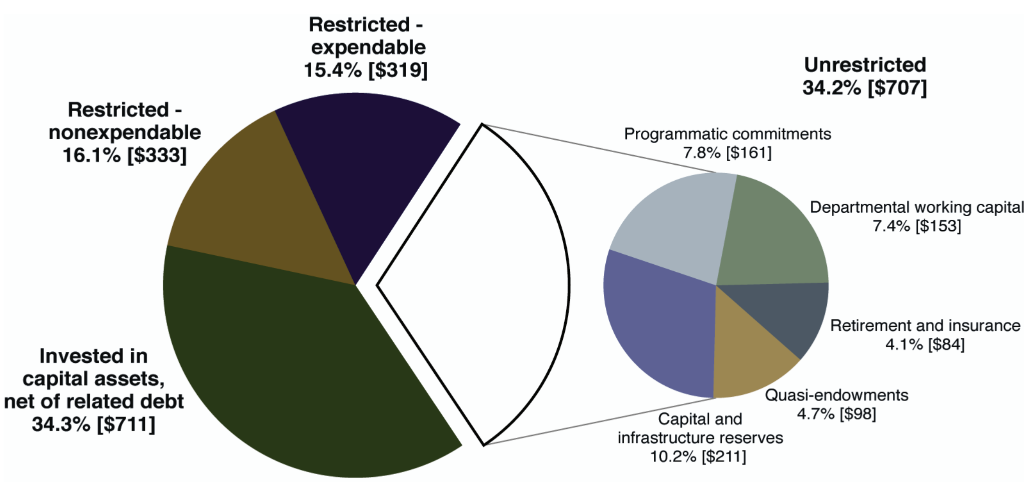
At June 30, 2005, the University had noncurrent debt and other obligations outstanding of $462 million compared with $384 million at June 30, 2004. This balance is comprised primarily of outstanding General Revenue Bonds of $423 million and $348 million in 2005 and 2004, respectively, a net increase largely due to the issuance of General Revenue Bonds Series 2005 ($85 million) in June, 2005. The University periodically 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, 2005, 2004, and 2003 are summarized as follows:

	2005	2004 (in millions)	2003
Invested in capital assets, net of related debt	$ 711	$ 704	$ 700
Restricted:			
Nonexpendable	333	285	241
Expendable	319	291	263
Total restricted	652	576	504
Unrestricted	707	613	514
Total net assets	$ 2,070	$ 1,893	$ 1,718

The following is a breakdown of net assets at June 30, 2005 (amounts are presented in millions of dollars):



TOTAL NET ASSETS $2.1 BILLION

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

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

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

Although unrestricted net assets are not subject to externally imposed restrictions, virtually all of the University's unrestricted net assets are designated for purposes to fulfill its various fiduciary responsibilities, including maintaining reserves for capital projects, future post-employment benefits, working capital for self-supporting departmental activities, and unrestricted quasi and term endowments.

The University's ongoing review of its infrastructure indicates a need to expend approximately $550 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. 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 expected benefit obligations related to postemployment healthcare and other non-pension benefits which were estimated at $800 million as of July 2003 (the latest actuarial calculation).

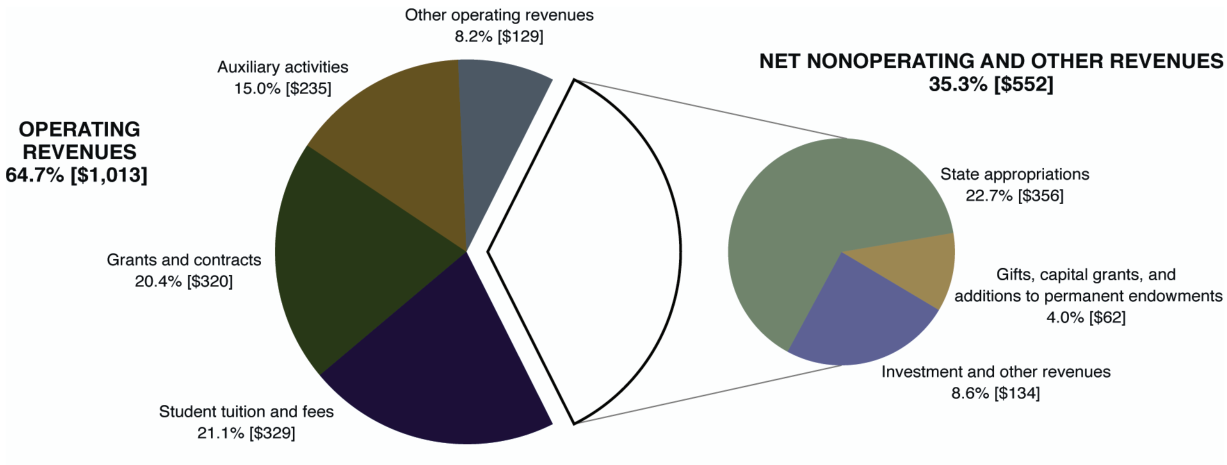
Statement of Revenues, Expenses, and Changes in Net Assets

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

A summarized comparison of the University's revenues, expenses, and changes in net assets for the years ended June 30, 2005, 2004, and 2003 follows:

	2005	2004	2003
		(in millions)	
Operating revenues:			
Student tuition and fees, net of allowances	$ 329	$ 308	$ 280
Grants and contracts	320	293	284
Auxiliary activities	235	220	209
Other operating revenues	129	119	99
Total operating revenues	1,013	940	872
Operating expenses:			
Instruction and departmental research	420	410	406
Research	236	215	214
Public services	172	158	158
Academic support	66	60	58
Student services	25	24	25
Scholarships and fellowships	29	27	24
Institutional support	61	56	59
Operation and maintenance of plant	102	83	86
Auxiliary enterprises	208	190	185
Depreciation	65	67	70
Other expenses	4	5	8
Total operating expenses	1,388	1,295	1,293
Operating loss	(375)	(355)	(421)
Nonoperating revenues (expenses):			
State appropriations	356	341	381
Gifts	37	49	39
Net investment income	148	135	61
Interest expense on capital asset related debt	(13)	(12)	(6)
Other net revenues (expenses)	(1)	(1)	2
Net nonoperating revenues	527	512	477
Income before other revenues	152	157	56
Capital grants and gifts	6	6	7
Additions to permanent endowments	19	12	14
Increase in net assets	177	175	77
Net assets, beginning of year	1,893	1,718	1,641
Net assets, end of year	$ 2,070	$ 1,893	$ 1,718

The following is a graphic illustration of total revenue by source for the year ended June 30, 2005 (amounts are presented in millions of dollars):



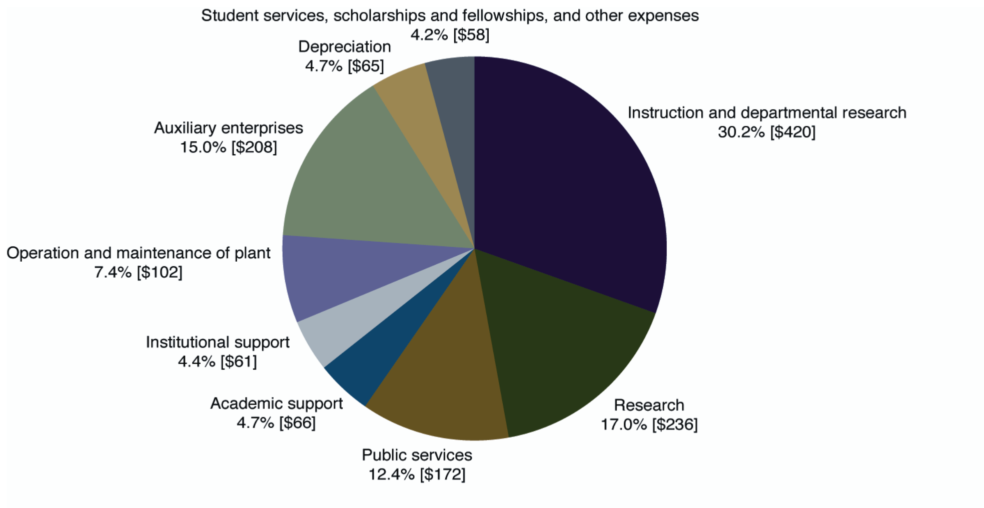
TOTAL REVENUE $1.6 BILLION

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

Operating revenues: The most significant source of operating revenue for the University was tuition and fees (net of scholarship allowances), totaling $329 million and $308 million at June 30, 2005 and June 30, 2004, respectively. Gross tuition and fees revenue increased 6.3% in 2005 and includes a 4.3% effective rate increase in tuition and fees and a 1.9% revenue increase from additional student credit hours taken. The 10.5% increase in 2004 reflects a 10.1% effective rate increase in tuition and fees. Other major revenue sources in 2005 include auxiliary services of $235 million ($220 million in 2004) and federal grants and contracts of $231 million ($212 million in 2004).

Net nonoperating and other revenues: The primary source of this net revenue is state appropriations, which totaled $356 million in 2005, an increase of $15 million (4.4%). For 2005, $287 million in funding for general operations was initially appropriated, but subsequently reduced a net $2 million, resulting in support for the year of $285 million. Additionally in 2005, the State allocated one-time funding of $9 million to refund a portion of prior year Executive Order budget cuts. Michigan State University Extension and the Michigan Agricultural Experiment Station appropriations remained at $62 million annually over the two year period. In 2004, appropriations decreased $40 million (10.5%) via a 6.7% beginning of the year cut for general operations, Michigan State University Extension, and the Michigan Agricultural Experiment Station, and an unscheduled 5.0% mid-year budget rescission for the general operations by the State. In 2005, other significant components of net nonoperating revenues, gift revenue and net investment income, decreased $12 million and increased $13 million, respectively. In 2004, gift revenue and net investment income increased $10 million and $74 million, respectively.

The following is a graphic illustration of operating expenses by source for the year ended June 30, 2005 (amounts are presented in millions of dollars):



TOTAL OPERATING EXPENSES $1.4 BILLION

During 2005, $828 million (59.6%) was expended for the core missions of the University, instruction and departmental research, research, and public services, compared with $783 million (60.8%) in 2004. Auxiliary enterprises (activities which provide services to students, faculty, staff, and the public) totaled $208 million (15.0%) and $190 million (14.7%) in 2005 and 2004, respectively. Expenses for the operation and maintenance of plant totaled $102 million (7.4%) and $83 million (6.4%) in 2005 and 2004, respectively. The increase in 2005 is due primarily to increased fuel costs and an increase in campus-wide non-capitalized repair and maintenance projects.

Economic Outlook

As a result of economic pressures affecting the State of Michigan, 2005-06 fiscal year State appropriations are slightly less than 2004-05 levels. The Board of Trustees approved increases of 9.4% and 13.5% for fall 2005 tuition and required fees for returning in-state and new in-state undergraduate students, respectively. The University's revenue mix is closely associated with the level of State support. There is a direct relationship between the growth of State appropriations and the increase in tuition and fee levels. Static or declining State appropriations generally result in increased tuition and fee levels. Continued adverse economic pressures affecting the State will, at best, result in minimal or declining adjustments in State appropriations for higher education.

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, 2005, $1.0 billion 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 financial statements of the business-type activities and discretely presented component unit of Michigan State University (the University) as of and for the years ended June 30, 2005 and 2004, which collectively comprise the University's basic financial statements 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. 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 business-type activities and the discretely presented component unit of the University as of June 30, 2005 and 2004, and the respective changes in financial position and, where applicable, cash flows 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 October 4, 2005 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, "Summary of Significant Accounting Policies," the University changed the policy on the definition of a cash equivalent in fiscal 2005.

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 30, 2005

STATEMENTS OF NET ASSETS
Michigan State University

	June 30, 2005	June 30, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,240,530	$ 16,643,810
Investments	177,087,569	197,362,366
Securities lending collateral	182,889,036	-
Accounts and interest receivable, net	127,528,955	123,163,839
Student loans receivable, net	23,947,020	22,546,037
Pledges receivable, net	12,238,063	12,664,583
Inventories and other assets	12,403,409	12,610,819
Total current assets	550,334,582	384,991,454
Noncurrent assets:		
Restricted cash and cash equivalents	16,573,585	17,476,393
Restricted investments	66,080,730	42,857,994
Endowment investments	906,778,971	745,911,025
Other investments	303,755,933	280,265,482
Student loans receivable, net	28,692,922	29,066,001
Pledges receivable, net	16,078,348	21,985,011
Investments in joint ventures	6,619,604	6,115,300
Unamortized bond origination costs	4,368,646	4,355,956
Capital assets, net	1,080,481,483	996,736,021
Total noncurrent assets	2,429,430,222	2,144,769,183
TOTAL ASSETS	**$ 2,979,764,804**	**$ 2,529,760,637**
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts and interest payable	$ 47,738,628	$ 31,275,609
Accrued personnel costs	49,461,334	47,681,177
Securities lending collateral	182,889,036	-
Accrued self-insurance liabilities	13,454,445	12,004,650
Payroll taxes and other payroll deductions	31,256,591	30,727,264
Deposits held for others	18,389,029	25,773,880
Deferred revenues	58,221,639	63,738,229
Current portion of long term debt and other obligations	22,402,092	16,779,085
Total current liabilities	423,812,794	227,979,894
Noncurrent liabilities:		
Accrued personnel costs	17,540,964	17,368,620
Accrued self-insurance liabilities	6,512,375	6,753,644
Long term debt and other obligations	461,620,721	384,378,880
Total noncurrent liabilities	485,674,060	408,501,144
Total liabilities	**909,486,854**	**636,481,038**
Net assets:		
Invested in capital assets, net of related debt	710,770,232	704,504,304
Restricted:		
Nonexpendable	332,554,686	284,917,207
Expendable	319,354,601	291,173,959
Unrestricted	707,598,431	612,684,129
Total net assets	**2,070,277,950**	**1,893,279,599**
TOTAL LIABILITIES AND NET ASSETS	**$ 2,979,764,804**	**$ 2,529,760,637**

See accompanying notes

STATEMENTS OF FINANCIAL POSITION
Michigan State University Foundation

	June 30, 2005	June 30, 2004
ASSETS		
Cash equivalents	$ 10,610,579	$ 19,431,574
Interest and dividends receivable	98,890	218,964
Assigned royalties receivable	-	8,279,994
Notes receivable	3,639,877	88,000
Other receivables	1,271,022	385,712
Investments:		
Marketable securities	236,368,052	216,163,906
Investments in limited partnerships	66,052,741	47,950,938
Venture capital	16,490,400	14,757,836
Cash value of life insurance	1,494,098	1,504,959
Land held for investment	2,755,333	2,437,333
Other investments	946,000	621,033
Investment in IP Ventures LLC	579,518	10,232
Investment in research park	3,348,658	3,340,780
Prepaid expenses	55,247	48,456
Furniture and equipment, net	4,213	7,526
TOTAL ASSETS	**$ 343,714,628**	**$ 315,247,243**
LIABILITIES AND NET ASSETS		
Liabilities:		
Accounts payable	$ 208,447	$ 623,617
Accrued expenses and other payables	1,059,340	554,902
Note payable	15,250,000	12,000,000
Trusts and annuities payable	6,634,398	6,079,107
Deferred gifts	433,000	433,000
Obligations under life estate agreements	109,650	149,668
Total liabilities	**23,694,835**	**19,840,294**
Net assets:		
Unrestricted	293,732,218	269,250,992
Temporarily restricted	14,221,999	14,665,032
Permanently restricted	12,065,576	11,490,925
Total net assets	**320,019,793**	**295,406,949**
TOTAL LIABILITIES AND NET ASSETS	**$ 343,714,628**	**$ 315,247,243**

See accompanying notes

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

Michigan State University

	Year ended June 30, 2005	Year ended June 30, 2004
OPERATING REVENUES		
Student tuition and fees	$ 373,307,566	$ 351,365,838
Less: scholarship allowances	44,007,144	43,072,601
Net student tuition and fees	329,300,422	308,293,237
State of Michigan grants and contracts	39,460,126	30,937,782
Federal grants and contracts	231,108,854	211,727,368
Local and private sponsored programs	49,011,971	50,566,439
Interest and fees on student loans	1,691,083	1,372,112
Departmental activities (net of scholarship allowances of $2,677,000 in 2005 and $2,737,000 in 2004)	127,118,487	117,094,955
Auxiliary activities (net of room and board allowances of $7,724,000 in 2005 and $8,211,000 in 2004)	235,324,557	219,335,129
TOTAL OPERATING REVENUES	**1,013,015,500**	**939,327,022**
OPERATING EXPENSES		
Instruction and departmental research	420,424,908	409,984,992
Research	235,980,709	214,528,107
Public services	171,812,259	158,220,805
Academic support	66,404,059	59,490,542
Student services	24,597,372	24,212,212
Scholarships and fellowships	28,814,667	26,631,200
Institutional support	60,919,671	55,941,277
Operation and maintenance of plant	102,358,145	83,188,784
Auxiliary enterprises	207,766,572	190,165,876
Depreciation	64,635,686	67,375,536
Other expenses	3,862,627	4,840,436
TOTAL OPERATING EXPENSES	**1,387,576,675**	**1,294,579,767**
Operating loss	(374,561,175)	(355,252,745)
NONOPERATING REVENUES (EXPENSES)		
State of Michigan appropriations	355,813,500	341,379,588
Gifts	36,657,827	48,562,320
Net investment income	148,071,543	135,031,446
Interest expense on capital asset related debt	(12,903,993)	(11,901,234)
Other expenses	(1,159,718)	(1,268,788)
Net nonoperating revenues	526,479,159	511,803,332
INCOME BEFORE OTHER REVENUES	**151,917,984**	**156,550,587**
Capital grants and gifts	5,778,879	6,779,982
Additions to permanent endowments	19,301,488	12,076,973
Increase in net assets	176,998,351	175,407,542
Net assets, beginning of year	1,893,279,599	1,717,872,057
NET ASSETS, END OF YEAR	**$ 2,070,277,950**	**$ 1,893,279,599**

See accompanying notes

STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS
Michigan State University Foundation

Year ended June 30, 2005

	Unrestricted Funds	Temporarily Restricted	Permanently Restricted	Total
REVENUE, GAINS AND OTHER SUPPORT:				
Contributions	$ 20,575	$ 7,987,688	$ 23,829	$ 8,032,092
Equity earnings - subsidiaries	743,676			743,676
Income from investments	10,488,466	61,802	411,540	10,961,808
Royalty income	6,414,963			6,414,963
Realized gain on sale of securities	3,212,249	891,257	135,384	4,238,890
Unrealized gain on securities	21,821,407	473,485	424,474	22,719,366
Net assets released from restrictions:				
Satisfaction of program restrictions	74,765	(59,776)	(14,989)	
Current year transfers	10,203,076	(9,797,489)	(405,587)	
TOTAL REVENUE, GAINS AND OTHER SUPPORT	52,979,177	(443,033)	574,651	53,110,795
EXPENSES:				
Contributions to the University	24,313,967			24,313,967
Patent expense	943,285			943,285
Investment management fees	1,225,606			1,225,606
Management and general	1,493,587			1,493,587
Postemployment retirement benefits	462,000			462,000
Promotional expenses - Management Company	59,506			59,506
TOTAL EXPENSES	28,497,951			28,497,951
Increase (decrease) in net assets	24,481,226	(443,033)	574,651	24,612,844
Net assets, beginning of year	269,250,992	14,665,032	11,490,925	295,406,949
NET ASSETS, END OF YEAR	$ 293,732,218	$ 14,221,999	$ 12,065,576	$ 320,019,793

Year ended June 30, 2004

	Unrestricted Funds	Temporarily Restricted	Permanently Restricted	Total
REVENUE, GAINS AND OTHER SUPPORT:				
Contributions	$ 48,315	$ 4,289,851	$ 8,628	$ 4,346,794
Equity loss - subsidiaries	(446,189)			(446,189)
Income from investments	5,019,287	(105,610)	284,333	5,198,010
Royalty income	20,763,437			20,763,437
Realized gain (loss) on sale of securities	(302,775)	13,878	112,167	(176,730)
Unrealized gain on securities	21,887,327	1,265,635	560,223	23,713,185
Net assets released from restrictions:				
Satisfaction of program restrictions	42,533	(26,280)	(16,253)	
Current year transfers	3,965,703	(3,528,977)	(436,726)	
TOTAL REVENUE, GAINS AND OTHER SUPPORT	50,977,638	1,908,497	512,372	53,398,507
EXPENSES:				
Contributions to the University	18,026,563			18,026,563
Patent expense	943,206			943,206
Investment management fees	979,250			979,250
Unrelated business tax				
Management and general	1,039,916			1,039,916
Postemployment retirement benefits	59,000			59,000
Promotional expenses - Management Company	62,677			62,677
TOTAL EXPENSES	21,110,612			21,110,612
Increase in net assets	29,867,026	1,908,497	512,372	32,287,895
Net assets, beginning of year	239,383,966	12,756,535	10,978,553	263,119,054
NET ASSETS, END OF YEAR	$ 269,250,992	$ 14,665,032	$ 11,490,925	$ 295,406,949

See accompanying notes

STATEMENTS OF CASH FLOWS
Michigan State University

	Year ended June 30, 2005	2004
Cash flows from operating activities		
Tuition and fees	$ 329,643,589	$ 309,326,720
Research grants and contracts	312,448,939	283,609,754
Auxiliary activities	238,054,500	210,704,095
Departmental activities	127,230,506	112,944,556
Interest and fees on student loans	1,691,083	1,372,112
Loans issued to students	(87,067,458)	(82,134,368)
Collection of loans from students	86,039,554	69,504,868
Scholarships and fellowships	(32,842,448)	(29,870,216)
Payments to suppliers	(338,765,159)	(276,097,470)
Payments to employees	(920,816,254)	(902,724,504)
Other payments	(34,168,517)	(12,508,921)
Net cash used by operating activities	(318,551,665)	(315,873,374)
Cash flows from noncapital financing activities		
State appropriations	355,485,171	348,275,898
Gifts	40,296,513	39,723,420
Endowment gifts	18,969,545	12,275,737
Federal loan program receipts	-	1,043,348
Federal loan program disbursements	-	(1,043,348)
Federal Family Education Loan Program receipts	211,538,994	173,434,916
Federal Family Education Loan Program disbursements	(210,256,097)	(159,928,880)
Net cash provided by noncapital financing activities	416,034,126	413,781,091
Cash flows from capital and related financing activities		
Capital appropriations	1,127,694	465,272
Capital gifts and grants	8,805,319	11,476,565
Proceeds from issuance of debt and other long term obligations	85,855,000	115,115,000
Purchase of capital assets	(141,923,358)	(110,897,692)
Proceeds from sale of capital assets	627,077	164,953
Principal paid on capital debt	(4,273,049)	(27,503,935)
Interest paid	(12,952,337)	(9,458,831)
Other receipts (payments)	1,934,699	(1,433,741)
Net cash used by capital and related financing activities	(60,798,955)	(22,072,409)
Cash flows from investing activities		
Investment income, net	102,531,931	68,446,424
Proceeds from sales and maturities of investments	23,365,639,305	1,737,853,847
Purchase of investments	(23,508,160,830)	(1,886,053,463)
Net cash used by investing activities	(39,989,594)	(79,753,192)
Net increase in cash	(3,306,088)	(3,917,884)
Cash, beginning of year	34,120,203	38,038,087
Cash, end of year	$ 30,814,115	$ 34,120,203

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:	**2005**	**2004**
Operating loss	$ (374,561,175)	$ (355,252,745)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation expense	64,635,686	67,375,536
Change in assets and liabilities:		
Accounts receivable	(4,064,313)	(16,316,847)
Student loans receivable	(1,027,904)	(12,629,500)
Inventories and other assets	207,410	1,086,463
Investments in joint ventures	(504,304)	10,280
Unamortized bond origination costs	(12,690)	(2,238,242)
Accounts payable	5,986,712	(3,290,859)
Accrued personnel costs	1,952,501	1,492,586
Payroll taxes and other payroll deductions	529,327	1,393,136
Deposits held for others	(7,384,851)	2,332,862
Deferred revenues	(5,516,590)	(1,240,071)
Accrued self-insurance liabilities	1,208,526	1,404,027
Net cash used by operating activities	$ (318,551,665)	$ (315,873,374)

See accompanying notes

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: Statement of Net Assets; Statement of Revenues, Expenses, and Changes in Net Assets; Statement of Cash Flows; and 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:

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, *Determining Whether Certain Organizations are Component Units*. 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 dedicated to benefit 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 discretely presented in the University's financial statements. In addition, the Foundation's significant notes are summarized in Footnote 4.

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 those under GASB. 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:

Cash and cash equivalents – Effective July 1, 2004, the University changed its policy with regard to the definition of cash equivalents in order to clarify which cash equivalents are considered to be in its investment portfolio. For purposes of the statement of cash flows, the University defines cash and cash equivalents as highly liquid, short-term (90 days or less) investments that bear little or no market risk. Cash equivalents held in the Intermediate Term Fixed Income Fund (IT), Common Investment Fund (CIF), and other investment funds are included in investments because the intent of these funds is long-term appreciation. Any cash balances held at the date of the financial statements are due to timing of reinvesting the proceeds within the fund. In order to present the classification of cash and cash equivalents under its changed policy on a consistent basis in both 2004 and 2005, the University reclassified cash equivalents of $197,362,366 to investments and reclassified restricted cash equivalents of $42,857,994 to restricted investments at June 30, 2004.

Restricted cash and cash equivalents and restricted investments – Restricted cash and cash equivalents and restricted investments represent unspent bond proceeds that are externally restricted for the construction or purchase of capital assets.

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 Statements 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 Statements 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, 5.75 percent of the average market value of endowment investments for the twenty quarters of the five 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 Statements 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.

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 as 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 cash equivalents

The University's cash and cash equivalents as of June 30, 2005 and 2004 were as follows:

	2005	2004
Cash and cash equivalents, current	$ 14,240,530	$ 16,643,810
Restricted cash and cash equivalents, noncurrent	16,573,585	17,476,393
Total cash and cash equivalents	$ 30,814,115	$ 34,120,203

Of the bank balances for cash, $100,000 of the total $4,889,000 in 2005 and $100,000 of the total $808,000 in 2004 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.

3. Investments

The University manages investments in accordance with policy approved by the Board of Trustees. The investment policy distinguishes guidelines for the Liquidity Pool (LP), Intermediate Term Fixed Income Fund (IT), and Common Investment Fund (CIF). In addition, the University has other investments that are restricted by external agreements or by special donor limitations (Other).

Securities Lending Transactions: The Board of Trustees authorized participation in a securities lending program whereby University securities are contractually loaned to approved borrowers against a pledge of collateral which is invested. The University had loaned securities with a market value of approximately $178,400,000 at June 30, 2005. One of the University's custodians is an agent in lending the University's domestic securities for cash collateral of 102 percent and international securities for cash collateral of 105 percent. At June 30, 2005, the University has no credit risk exposure to borrowers because the amounts the University owes the borrowers exceed the amounts the borrowers owe the University. The contract with the lending agent requires it to indemnify the University if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent). All securities loans can be terminated on demand by either the University or the borrower. As a means of managing the University's interest rate risk, the securities lending agreement limits the difference between the average weighted maturity of securities loans and the average weighted maturity of the cash collateral investment portfolio to a maximum of 90 days. At June 30, 2005, the difference was less than 90 days.

As of June 30, 2005, the University had the following investments:

	June 30, 2005 (in thousands)					
Investment type	LP	IT	CIF	Securities Lending	Other	Total
Repurchase agreements	$ -	$ -	$ -	$ 105,289	$ -	$ 105,289
External investment pools	3,192	196,058	606,382	-	22,337	827,969
U.S. Treasury bonds	53,811	-	29,826	-	67	83,704
U.S. Government agencies	43,952	-	39,520	10,000	-	93,472
Corporate bonds	44,942	-	29,598	67,600	279	142,419
Asset-backed securities	97,271	-	67,063	-	85	164,419
Domestic common stock	-	-	198,110	-	4,460	202,570
Domestic convertible preferred stock	-	-	650	-	-	650
International equities	-	-	16,100	-	-	16,100
Total	$ 243,168	$ 196,058	$ 987,249	$ 182,889	$ 27,228	$ 1,636,592

Interest Rate Risk: As a means of managing its exposure to fair value losses arising from increasing interest rates, University investment policy limits the average duration of the LP portfolio to three years and the IT and CIF portfolios to six years. At June 30, 2005, the University is in compliance with its investment policy with regard to average duration. University policy does not address average duration of investments by investment type.

The maturities of fixed income investments as of June 30, 2005 are as follows:

	June 30, 2005 Fixed Income Investment Maturities (in thousands)				
Investment type	Less than 1 year	1-5 years	6-10 years	More than 10 years	Total
Repurchase agreements	$ 105,289	$ -	$ -	$ -	$ 105,289
External investment pools	3,653	58	197,227	1,674	202,612
U.S. Treasury bonds	-	65,929	7,696	10,079	83,704
U.S. Government agencies	16,783	19,343	11,058	46,288	93,472
Corporate bonds	51,142	68,397	14,236	8,644	142,419
Asset-backed securities	-	74,665	9,042	80,712	164,419
Total	$ 176,867	$ 228,392	$ 239,259	$ 147,397	$ 791,915

The University invests in asset-backed securities such as mortgage pass-through securities issued by U.S. Government agencies. These securities are based on cash flows from interest payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates.

Credit Risk: As a means of managing credit risk, University investment policy limits fixed income investments at time of purchase to the following ratings issued by nationally recognized statistical rating organizations: LP portfolio – short-term A1/P1, long-term BBB; IT portfolio – short-term A2/P2, long-term B; CIF portfolio – short-term A2/P2, long-term BB. Thereafter, the minimum quality for all three portfolios is limited to AA. At June 30, 2005, the University is in compliance with its credit risk policy for each portfolio. University policy does not address credit risk by investment type.

The Standard & Poor's credit ratings for fixed income investments at June 30, 2005 are as follows:

	As of June 30,2005 (in thousands)						
Rating	Repurchase Agreements	External investment pools	U.S. Treasury bonds	U.S. Government agencies	Corporate bonds	Asset-backed securities	Total
AAA	$ -	$ -	$ -	$ 25,613	$ 30,579	$ 73,822	$ 130,014
AAA	34,067	-	-	-	29,693	-	63,760
AAA	71,222	-	-	-	55,188	-	126,410
BBB	-	-	-	-	23,145	1,633	24,778
BB	-	-	-	-	2,289	766	3,055
Below BB	-	-	-	-	-	-	-
Not rated	-	202,612	83,704	67,859	1,525	88,198	443,898
Total	$ 105,289	$ 202,612	$ 83,704	$ 93,472	$ 142,419	$ 164,419	$ 791,915

Concentration of Credit Risk: As a means of managing the concentration of credit risk, University investment policy limits the concentration of investments as follows: LP portfolio – No more than 15 percent of the portfolio's market value may be invested in dollar denominated foreign securities of developed countries (i.e., no emerging markets). No more than 10 percent of the portfolio's market value will be invested in (1) Rule 144A securities or (2) securities of any single issuer, except those which are obligations of, or fully guaranteed as to both principal and interest by, the U.S. Government or its agencies. IT portfolio – No more than 10 percent of the portfolio's market value may be invested in securities below BBB. No more than 30 percent of the portfolio's market value may be invested in securities denominated in foreign currencies. No more than 10 percent of the portfolio's market value will be invested in securities of any single issuer, except those which are obligations of, or fully guaranteed as to both principal and interest by, the U.S. Government or its agencies. CIF portfolio – Investments are managed in accordance with asset allocation guidelines and manager guidelines at time of manager appointment.

As of June 30, 2005, not more than 5 percent of the University's total investments were invested in any one security.

Custodial Credit Risk: For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the University will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. University investment policy does not limit the value of investments that may be held by an outside party. Of the University's investments, $1,455,000 of the U.S. Treasury bonds, $72,763,000 of the U.S. Government agencies, $72,313,000 of the Corporate bonds, $164,419,000 of the Asset-backed securities, $149,627,000 of the domestic equities, $12,683,000 of the international equities, and $29,319,000 of the external investment pools are held by the University's counterparty, not in the name of the University. Consistent with the University's securities lending agreement, $182,889,000 was held by the counterparty that was acting as the University's agent in securities lending transactions.

Foreign Currency Risk: University investment policy limits foreign currency risk on its IT portfolio to 30% of the portfolio's market value.

4. 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, 2005 and 2004 are summarized as follows:

	2005		2004	
	Cost	Market	Cost	Market
Short-term investments	$ 14,211,000	$ 14,211,000	$ 1,053,000	$ 1,053,000
Domestic equities	38,883,000	44,927,000	39,850,000	41,382,000
Foreign equities	54,589,000	61,610,000	47,959,000	44,077,000
Other equities	784,000	822,000	5,360,000	5,726,000
Fixed income	46,096,000	47,546,000	60,489,000	59,963,000
Mutual funds – Equities	47,419,000	52,488,000	46,969,000	49,454,000
Mutual funds – Fixed	14,528,000	14,764,000	14,331,000	14,509,000
Limited partnerships	58,177,000	66,053,000	41,432,000	47,951,000
	$ 274,687,000	$ 302,421,000	$ 257,443,000	$ 264,115,000

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 in the Statements of Financial Position is stated at fair market value.

5. Accounts and interest receivable

The composition of accounts and interest receivable at June 30, 2005 and 2004 is summarized as follows:

	2005	2004
State operating appropriations	$ 61,234,000	$ 60,906,000
Research and sponsored programs	45,527,000	42,240,000
Departmental activities	17,376,000	15,882,000
Interest receivable	2,972,000	1,872,000
Other	9,002,000	9,614,000
	136,111,000	130,514,000
Less: allowance for doubtful accounts	8,582,000	7,350,000
Net accounts and interest receivable	$ 127,529,000	$ 123,164,000

6. Student loans receivable

Student loans receivable at June 30, 2005 and 2004 are summarized as follows:

Description	2004	Distributed	Collected	2005	Current Portion
Federal Family Education Loan Program	$ 12,017,000	$ 74,452,000	$ 73,925,000	$ 12,544,000	$ 12,544,000
Perkins Federal Loan Program	35,134,000	7,153,000	7,290,000	34,997,000	8,781,000
Other	8,356,000	5,463,000	4,720,000	9,099,000	2,775,000
	55,507,000	$ 87,068,000	$ 85,935,000	56,640,000	24,100,000
Allowance for uncollectible loans	(3,895,000)			(4,000,000)	(153,000)
Net student loan receivable	$ 51,612,000			$ 52,640,000	$ 23,947,000

Description	2003	Distributed	Collected	2004	Current Portion
Federal Family Education Loan Program	$ -	$ 70,155,000	$ 58,138,000	$ 12,017,000	$ 12,017,000
Perkins Federal Loan Program	35,122,000	7,026,000	7,014,000	35,134,000	8,002,000
Other	7,743,000	4,953,000	4,340,000	8,356,000	2,667,000
	42,865,000	$ 82,134,000	$ 69,492,000	55,507,000	22,686,000
Allowance for uncollectible loans	(3,882,000)			(3,895,000)	(140,000)
Net student loan receivable	$ 38,983,000			$ 51,612,000	$ 22,546,000

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.

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. Under this program, the University loans funds directly to students and subsequently sells the loans at a premium to a third party after 90 days. The University holds a bank line of credit to facilitate the distribution of the loans (see Footnote 8).

For the year ended June 30, 2005, the University distributed $115,763,000 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.

7. Pledges receivable

Payments on pledges receivable at June 30, 2005, 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 percent.

2006	$ 13,698,000
2007	6,651,000
2008	4,386,000
2009	3,219,000
2010	1,328,000
2011 and beyond	2,374,000
Total discounted pledges receivable	31,656,000
Less: allowance for uncollectible pledges	3,340,000
Net pledges receivable, June 30, 2005	28,316,000
Less: current portion	12,238,000
Noncurrent portion	$ 16,078,000

8. Long term debt and other obligations

Long term debt and other obligations for the years ended June 30, 2005 and 2004 are summarized as follows:

	2004	Borrowed	Retired	2005	Current Portion
General Revenue Bonds:					
Series 2005	$ -	$ 84,580,000	$ -	$ 84,580,000	$ -
Series 2003A	80,570,000			80,570,000	1,735,000
Series 2003B	23,695,000	-	155,000	23,540,000	160,000
Series 2003C	10,850,000	-	-	10,850,000	180,000
Series 2002A	53,780,000	-	-	53,780,000	2,135,000
Series 2002B	11,480,000	-	-	11,480,000	1,075,000
Series 2000A-2	48,835,000	-	-	48,835,000	-
Series 2000A-1	57,115,000	-	1,000,000	56,115,000	260,000
Series 1998A-2	51,935,000	-	-	51,935,000	-
Series 1998A-1	11,655,000	-	2,130,000	9,525,000	2,220,000
Series 1996A	1,220,000	-	595,000	625,000	625,000
	351,135,000	84,580,000	3,880,000	431,835,000	8,390,000
Federal student loan deposits	33,608,000	1,107,000	232,000	34,483,000	-
Short term line of credit	13,506,000	94,669,000	94,261,000	13,914,000	13,914,000
Lease Obligations	2,909,000	1,275,000	393,000	3,791,000	98,000
	$ 401,158,000	$ 181,631,000	$ 98,766,000	$ 484,023,000	$ 22,402,000

	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
Lease Obligations	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

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 2005: from fiscal 2008 through 2034
- 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 percent to 5.00 percent and mature serially through fiscal 2009.

The Series 1996A bonds bear interest at rates varying from 4.55 percent to 4.65 percent and mature serially through fiscal 2006.

Interest expense was $12,904,000 and $11,901,000 (net of capitalized interest of $911,000) for 2005 and 2004, respectively.

Swap payments and associated debt: Using rates as of June 30, 2005, 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
2006	$ 2,845,000	$ 428,000	$ 5,545,000	$ 8,517,000	$ 8,730,000	$ 26,065,000
2007	2,320,000	300,000	7,535,000	9,504,000	9,898,000	29,557,000
2008	2,430,000	188,000	9,725,000	9,295,000	9,742,000	31,380,000
2009	2,555,000	64,000	10,050,000	9,058,000	9,525,000	31,252,000
2010	-	-	13,085,000	8,782,000	9,265,000	31,132,000
2011-2015	-	-	61,560,000	39,673,000	42,105,000	143,338,000
2016-2020	-	-	74,735,000	31,796,000	34,163,000	140,694,000
2021-2025	-	-	88,450,000	22,262,000	24,401,000	135,113,000
2026-2030	-	-	95,255,000	11,659,000	13,234,000	120,148,000
2030-2034	-	-	55,745,000	2,077,000	2,802,000	60,624,000
Total	$ 10,150,000	$ 980,000	$ 421,685,000	$ 152,623,000	$ 163,865,000	$ 749,303,000

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

At June 30, 2005, the University owed $13,914,000 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 6). Principal amounts outstanding under this line of credit bear interest equal to sixty basis points over a thirty day trailing average of the one-month London Interbank Offering Rate (LIBOR), and accrued interest is payable monthly. Payment terms of the principal balance outstanding at June 30, 2005 vary, but do not exceed six months.

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 2005 and 2004 were as follows:

	2005	2004
Balance, beginning of year	$ 65,050,000	$ 63,557,000
Additions	4,149,000	3,157,000
Reductions	(2,197,000)	(1,664,000)
Balance, end of year	67,002,000	65,050,000
Less: current portion	49,461,000	47,681,000
Noncurrent portion	$ 17,541,000	$ 17,369,000

9. 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 percent of their base salary or wages and the University contributes 10.0 percent 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, 2005 and 2004 were as follows:

	2005	2004
University contributions	$ 51,841,000	$ 50,892,000
Employee contributions	25,921,000	25,446,000

In addition, the University has a single-employer, defined benefit plan covering approximately 1,000 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, 2005.

10. 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 2005 and 2004. The University recognizes the cost of providing those benefits on a pay-as-you-go basis. Those costs totaled $23,243,000 for 2005 and $20,004,000 for 2004 and are included in operating expenses in the Statements of Revenues, Expenses, and Changes in Net Assets (see Footnote 18).

11. 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.

12. Commitments

At June 30, 2005, 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 $79,261,000 and are to be funded from state and State Building Authority (SBA) appropriations, private gifts, debt proceeds, or other University funds. Certain University facilities 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, 2005, 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, 2005, $72,316,000 of the initial $138,050,000 investment commitment remains outstanding.

13. 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. The University carries excess commercial medical professional liability insurance to manage the liability. The liability is reported at its present value of $5,411,000 as of June 30, 2005. The discount rate used was 5.0 percent.

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 $3,281,000 as of June 30, 2005. The discount rate used was 6.0 percent.

Changes in the total reported general, professional, and self-insured employee benefit liabilities during 2005, 2004, and 2003 were as follows:

	2005	2004	2003
Balance, beginning of year	$ 18,758,000	$ 17,354,000	$ 15,779,000
Claims incurred and changes in estimates	90,433,000	82,719,000	76,859,000
Claim payments	(89,224,000)	(81,315,000)	(75,284,000)
Balance, end of year	19,967,000	18,758,000	17,354,000
Less: current portion	13,455,000	12,005,000	11,353,000
Noncurrent portion	$ 6,512,000	$ 6,753,000	$ 6,001,000

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.

14. 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 provides high technology cross-sectional diagnostic imaging services. 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 percent member in each of the foregoing not for profit corporations. Additionally, the University is a 33 percent 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.

15. Capital assets and collections

Capital asset and collection activity for the years ended June 30, 2005 and 2004 follows:

	2004	Additions (Deductions)	Disposals	2005
Non-depreciated capital assets:				
Land	$ 19,517,000	$ -	$ -	$ 19,517,000
Construction in progress	85,939,000	52,425,000	-	138,364,000
Collections	5,138,000	266,000	-	5,404,000
	110,594,000	52,691,000	-	163,285,000
Depreciated capital assets:				
Buildings and site improvements	1,349,994,000	82,051,000	(5,000)	1,432,040,000
Equipment and other	430,164,000	17,361,000	(12,787,000)	434,738,000
Less: accumulated depreciation				
Buildings and site improvements	(573,888,000)	(38,274,000)	5,000	(612,157,000)
Equipment and other	(320,128,000)	(26,362,000)	9,065,000	(337,425,000)
	886,142,000	34,776,000	(3,722,000)	917,196,000
Total capital assets	$ 996,736,000	$ 87,467,000	$ (3,722,000)	$ 1,080,481,000

	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:				
Building 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

16. Net assets

Restricted and unrestricted net assets for the years ended June 30, 2005 and 2004 follows:

	2005	2004
Restricted - nonexpendable:		
Permanent endowments	$ 332,555,000	$ 284,917,000
Restricted - expendable:		
Gifts, endowment income and sponsored programs	$ 170,319,000	$ 148,927,000
Quasi and term endowments	125,446,000	112,088,000
Capital projects	16,124,000	22,946,000
Student loans	7,466,000	7,213,000
Total	$ 319,355,000	$ 291,174,000
Unrestricted:		
Designated	$ 706,911,000	$ 616,547,000
Uncommitted	687,000	(3,863,000)
Total	$ 707,598,000	$ 612,684,000

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.

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, 2005.

Objective of the swaps: In order to protect against the potential of rising interest rates, the University has entered into ten 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, 2005 are listed below. 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	Outstanding Notional Amount	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Value	Swap Termination Date	Counterparty/ Counterparty Credit Rating
1998A-2	$ 51,935,000	7/1/1998	4.604%	BMA Municipal Swap Index	$ (6,682,000)	8/15/2022	Ambac Financial Services/Aaa
2000A-1 & 2000A-2	98,545,000	5/2/2002	4.074%	67% USD-LIBOR-BBA	(13,277,000)	8/15/2029	Lehman Brothers Special Financing Inc./A2
2002A	51,660,000	10/17/2002	3.390%	67% USD-LIBOR-BBA	(2,383,000)	8/15/2032	UBS Warburg/Aa2
2002A	2,120,000	10/17/2002	3.530%	67% USD-LIBOR-BBA	(146,000)	8/15/2022	UBS Warburg/Aa2
2002B	9,440,000	10/17/2002	4.330%	USD-LIBOR-BBA	(167,000)	8/15/2018	UBS Warburg/Aa2
2002B	2,040,000	10/17/2002	5.280%	USD-LIBOR-BBA	(212,000)	8/15/2022	UBS Warburg/Aa2
2003A	80,570,000	12/11/2003	3.618%	67% USD-LIBOR-BBA	(6,174,000)	2/15/2033	Lehman Brothers Special Financing Inc./A2
2003B	23,540,000	12/11/2003	3.479%	67% USD-LIBOR-BBA	(1,321,000)	2/15/2026	UBS Warburg/Aa2
2003C	10,850,000	12/11/2003	5.330%	USD-LIBOR-BBA	(1,173,000)	2/15/2033	Lehman Brothers Special Financing Inc./A2
2005	84,580,000	7/2/2007	3.647%	67% USD-LIBOR-BBA	(4,483,000)	2/15/2034	Lehman Brothers Special Financing Inc./A2
Total	$415,280,000				$ (36,018,000)		

Fair Value: Primarily because interest rates have declined since their execution, the swaps in total have a negative fair value as of June 30, 2005. 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, four swaps, approximating 66 percent of the notional amount of swaps outstanding, are held with Lehman Brothers Special Financing, Inc, which is rated A1. Of the remaining swaps, the University holds five agreements with UBS Warburg, rated Aa2, making up approximately 21 percent of the outstanding notional value. The remaining swap is held with AMBAC Financial Services, rated Aaa.

As of June 30, 2005, (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 not exposed to credit risk because all swaps had negative fair values. However, should interest rates change and the fair values of the swaps become positive, the University would be exposed to credit risk in the amount of the swaps' fair value. The following table demonstrates the thresholds and minimum transfers for collateralization:

Credit					Lehman Brothers Special Financing, Inc.			
Rating	AMBAC		UBS Warburg		Series 2000A*		Series 2003A & C, 2005	
(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 swaps expose the University to basis risk should the rates resulting from the BMA swap index for the 1998A-2 swap, 67 percent of USD-LIBOR-BBA for the 2000A-1, 2000A-2, 2002A, 2003A, 2003B, and 2005 swaps, and USD-LIBOR-BBA for the 2002B and 2003C swaps not equal the rate the University pays.

Rollover risk: The University is exposed to rollover risk on its 1998A-2 swap that may be terminated on or after July 1, 2008, prior to the August 15, 2022 maturity of the associated debt, if certain interest rate conditions are met. If the counterparty is able to exercise its conditional termination option, the University will not realize the synthetic rate offered by the swap on the underlying debt issue.

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 a swap is terminated, the variable-rate bonds would no longer carry a synthetic fixed interest rate. Also, if at termination a 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. 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. 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. 47, *Accounting for Termination Benefits*, effective with the fiscal year ending June 30, 2006. The University will be required to disclose certain information regarding termination benefit arrangements, if any. The University has not yet determined the full impact of GASB Statement No. 47 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; Gregory J. Deppong, Manager of Financial Analysis; and Robert J. Patterson, Manager of Cost Analysis.

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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 financial statements of Michigan State University (the University) and its discretely presented component unit as of and for the year ended June 30, 2005, and have issued our report thereon dated September 30, 2005. Our report included an explanatory paragraph indicating the University changed its policy on the definition of a cash equivalent in fiscal 2005. 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. 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.*

Our consideration of internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grants, and other matters did not include the entity audited by the other auditors referred to in the previous paragraph. The findings, if any, of those other auditors are not included herein.

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 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 30, 2005