MICHIGAN STATE UNIVERSITY

Advancing Knowledge. Transforming Lives.

FINANCIAL REPORT 2005-2006

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MICHIGAN STATE
UNIVERSITY

This report presents the financial position and results of operations of Michigan State University for the fiscal years ended June 30, 2006, and June 30, 2005. 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. The June 30, 2006 financial statements have been audited by Plante & Moran PLLC, 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 128 countries worldwide enroll at Michigan State each year in 200 programs of undergraduate and graduate study. Citing MSU's commitment to strategic positioning and its strong international agenda, the Higher Learning Commission of the North Central Association of Schools and Colleges recently granted MSU a full 10-year regional accreditation to 2016.

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 appropriately utilizing 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 $1.20 billion by 2007. As of the date of this letter, our goal has been met.

The university's ongoing review of its infrastructure indicates a need to expend approximately $700 million over the next 10 years to modernize and renovate aging teaching, research, housing and other support facilities, utility systems, and roads, and to upgrade administrative and other campus-wide technology systems. 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 gifts, grants, and capital appropriations.

As a great public research university–one of the top 100 in the world–and as the nation's pioneer land-grant university, Michigan State honors the values of our past and draws from them the energy to innovate our future around the world, across the nation, and at home. We've pledged that by 2012, Michigan State University will be recognized worldwide as the leading land-grant research university, the model for "world-grant." We are well on our way.

Fred L. Poston
Vice President for Finance and Operations and Treasurer
October 30, 2006

OFFICE OF THE
VICE PRESIDENT FOR FINANCE AND OPERATIONS AND TREASURER
Michigan State University
416 Administration Building
East Lansing, MI
48824-1046
517/355-5016
FAX: 517/353-6772

In preparing to face world responsibility, American education should not overlook the tasks that remain to be finished on the domestic scene. By their very nature, they affect everything we seek to do on the international scene …

In world affairs we, as a nation, have the broadest horizon and the greatest challenge to face. The very size and scope of this international challenge, plus the vital inter-relatedness of our domestic and foreign affairs, make the international responsibility of this nation of primary concern to the American people, and hence, of necessity, of primary concern to American education.

— John Hannah, MSU President 1941–1969

FROM LAND-GRANT TO WORLD-GRANT: A LEGACY AND VISION

Michigan State University was founded in 1855 to serve as a "State Agricultural School"—the first institution of higher learning in the United States to teach scientific agriculture. More important, it was conceived as a bold experiment in higher education, fusing the classical model of a liberal education with the cutting-edge practical and scientific knowledge of the day.

Most of all, it was envisioned as a people's university, a revolutionary idea offering all who had the talent and determination—not just those preparing themselves for a handful of prestigious professions—the opportunity to become citizen leaders and to participate in shaping a new, broader knowledge base that, in turn, would help shape a rapidly changing nation. As Joseph R. Williams, MSU's first president, put it, the new college was "good enough for the proudest and open to the poorest."

The land-grant model was not simply about establishing agricultural colleges, as some believe. Rather, it was a powerful new model of higher education, one that—over the next 150 years—would become a model, first for our national system of land-grant universities, signed into existence by Abraham Lincoln, and eventually for institutions of higher education around the world.

As the pioneer land-grant institution, we built a solid foundation on the core values of quality, inclusion, and connectivity, the same core values that guide us today as we look to the future.

Today, Michigan State stands as one the top 100 universities in the world and among the great research universities of the Association of American Universities.

Much of that success is the result of being able not only to address the challenges of the day, but to anticipate those of the future, and then to prepare and adapt to meet them successfully. That is the objective of Michigan State's strategic plan, "Boldness by Design," and that's what we mean by becoming a "world-grant" university.

World-grant means a new paradigm built on existing strengths—our own and those of our partners. It means anticipating what comes next to prepare for an uncertain future—around the world, across the nation, and at home. It means innovating for that future at the same time we honor the values of our past. It means constantly adapting to ensure we offer our students, scholars, and stakeholders the kinds of opportunities and possibilities that will make a lasting difference, both for them and for generations to come.

Most important, it means staying true to our core values of quality, inclusion, and connectivity.

By offering broad access to a high-quality education, connecting society to the knowledge we discover, and advancing that knowledge by applying it in practical ways, we enhance quality of life—not just for an individual or here in East Lansing, but on a global scale.

BOLDNESS BY DESIGN

World-grant means nothing less than doing our part to change the world. Again.

In fall 2005, Michigan State introduced its "Boldness by Design" initiative that provides the framework for our transformation from land-grant to world-grant. Our pledge to our stakeholders is to become the prototype world-grant—the first world-grant university—by 2012.

This is a time of significant change and challenge: trade, poverty, and environmental issues cross international boundaries; global competition is increasing, making it more difficult to attract and retain the most talented students, faculty, researchers, partners, and funding; and society's expectations have become more intense than ever that its universities will assume a lead role in building the national and local economies, deliver more breakthrough discoveries, and address the most urgent social and cultural problems, all with less and less public funding support.

"Boldness by Design" will allow us to build and intensify our level of engagement and competitiveness and to claim our future. We have identified five strategic imperatives to help us focus our decisions, activities, and resources across the university:

- 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.

As the pioneer land-grant institution, we built a solid foundation on the core values of quality, inclusion, and connectivity.

Our world-grant mission is to be a premier, research-intensive, land-grant university of international scope. When people think of an engaged, global university, we want them to think first of Michigan State.

BUILDING FOR THE FUTURE

As we look around MSU today, we see tremendous successes and enormous potential. We know how to innovate by moving knowledge out of classrooms and laboratories and by putting it to work—not just knowledge we discover, but also knowledge we glean from the discoveries of others. We know how to build and work in partnerships. We know how to develop innovative and integrally connected teaching models, so that we can contribute locally, regionally, nationally, and internationally.

Michigan State has been engaged in this way around the world for generations. While no single institution or even nation can address all the challenges we face in today's rapidly changing world, Michigan State is increasingly becoming a "go to" place for leadership and solutions.

And that truly is the basis for "world-grant."

ATTRACTING INVESTMENT, DELIVERING STEWARDSHIP

In October, our capital campaign—The Campaign for MSU—reached its goal of $1.2 billion nearly a year ahead of schedule. All those who have helped us reach this goal, and our other partners who invest in us, show by their actions that they believe in our value today, but more important, that they believe in our vital role in creating a different tomorrow.

But we still have work to do. The campaign goal for endowments is $450 million, but we currently stand at only $362 million. Endowed funds are critical to the university because they help sustain and ensure the future excellence of core academic programs. So we are placing the highest priority in the coming year on raising the remaining $88 million—more than we've ever before raised for endowments in a single year.

As we move forward, we continue to put every dollar possible into opportunities for students and developing critical programs and initiatives. And we continue to place great emphasis on controlling costs so that dollars saved, not just new dollars, can be directed toward our strategic priorities and emerging opportunities.

FUELING ECONOMIC DEVELOPMENT

Being an engine for economic development has always been an essential part of our land-grant mission.

Our economy is going through a period of profound change, from what we now think of as a "traditional economy" to a new, knowledge economy.

MSU already is engaged all over the state, working to advance economic, cultural, and social entrepreneurship, connecting liberal arts to the professions and culture to day-to-day life in ways that strengthen our ability to recruit and retain the intellectual capital that will drive the new economy in Michigan, across the nation, and around the world.

As we look around MSU today, we see tremendous successes and enormous potential.

Michigan State 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 that will subsume the event-driven initiatives of the past into a comprehensive, proactive, sustainable force.

MSU played a key role in developing a SmartZone to advance economic development in Greater Lansing and in creating the Prima Civitas partnership to launch an aggressive economic development initiative in mid-Michigan, and we're currently involved in "region-building" projects in 13 Michigan counties. We have economic development projects in Grand Rapids, the Thumb area, southeastern Michigan, Oakland County, and more.

MSU Extension has a presence in all counties in the state, linking them to MSU's knowledge and resources and identifying and addressing specific community needs, whether in farmers' fields or on city streets.

Our work is geographically focused, tailored to the needs and opportunities of each area. So while we are in every part of the state, our efforts are unique in each location.

MSU's medical schools and affiliated teaching hospitals have statewide impact. To advance both economic development and community health care in Grand Rapids, we are progressing toward establishing the Michigan State University-West Michigan Medical School to serve the community in and around Grand Rapids.

We've won major funding in food safety, water safety, game theory, identity theft, education, nanotechnology, and more.

We've begun building leadership in the vital areas of homeland security strategies by bringing together, in classic MSU style, cross-disciplinary collaborations to address national security needs.

There have been 26 Michigan State University business spin-offs in the past three years, and through the MSU Product Center for Agriculture and Natural Resources, the university also helped launch 38 other businesses across Michigan in 2005.

MSU will continue to be a leader in developing Michigan's economy. As one of the world's leading research universities, we will continue to be a vital source of the research and development inputs and the technology and science workforce—the human intellectual capital—that will fuel economic growth.

INNOVATION AT HOME AND AROUND THE GLOBE

Michigan State has a proven record of delivering strong results for Michigan's people and Michigan's economy.

As the state's land-grant university, MSU has always served Michigan first. But at the same time, an international dimension has been woven into the fabric of the institution from nearly the beginning.

This year we celebrate the 50th anniversary of the founding of the International Studies and Programs at Michigan State. ISP was the first entity of its kind among U.S. universities, one dedicated to fostering international programming efforts across the entire institution.

But global engagement at Michigan State goes back much farther than 50 years ago when John Hannah appointed our first dean of International Studies and Programs.

Our first international student, Charles C. Georgeson of Denmark, arrived on campus in 1878. He soon was followed by students from Japan and Russia.

Today, one in every 13 students enrolled at Michigan State is an international student, an increase of some 24 percent over 10 years ago, and nearly a third of MSU's graduate students are from other countries.

While formal study abroad programs did not begin until much later, Frank Kedzie, who later served as MSU's eighth president, went to Germany in 1890 and 1898 to study the sugar beet industry.

Sugar beets are an important part of Michigan's agricultural economy, particularly as we work to identify alternative sources for energy and other petroleum-based products in building a bio-economy for Michigan.

Michigan State is the top U.S. public university for study abroad, with a diverse set of program options on all continents, including Antarctica, that fulfill academic needs for students in any major.

MSU has made study abroad an integral part of the undergraduate experience. For previous generations, international experience at the university level was considered an advantage. In today's world, one cannot be considered well-educated and well-prepared without some sort of international experience or understanding—it has become a necessity.

Land-grant is outreach. World-grant is global engagement and outreach beyond our national borders.

As Michigan State University continues its transformation from land-grant to world-grant, we will become the leader in establishing the kind of institution most relevant and most needed today: a research university truly engaged at the global level to advance knowledge and transform lives.

World-grant means nothing less than doing our part to change the world. Again.

As such, our responsibilities will broaden and the complexity of our activities and our commitments will increase. And as we dedicate ourselves to continually bringing the best of the world to Michigan and sharing the best of Michigan with the world, the citizens of this state—and the world—will benefit in myriad ways.

MAKING A DIFFERENCE

Michigan State University believes that all of those who invest in us deserve a solid return on their investment.

We commit to providing students with an outstanding education and our graduates with a degree that will continue to increase in value in the future. We commit to discover, create, and apply knowledge in ways that will make a difference and improve quality of life—throughout Michigan, across the nation, and around the world.

Introduction

The following discussion provides an overview of the financial position of Michigan State University (the "University") for the years ended June 30, 2006 and 2005 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 its 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 financial information included in the University's financial report to account for these differences.

The University's financial statements, related footnote disclosures, and discussion and analysis (which excludes the Foundation), have been prepared by management. The discussion and analysis 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, 2006, 2005, and 2004 follows:

	2006	2005	2004
		(in millions)	
Current assets	$ 450	$ 550	$ 385
Noncurrent assets:			
Restricted cash and cash equivalents and restricted investments	28	83	60
Endowment and other investments	1,363	1,211	1,026
Capital assets, net	1,205	1,080	997
Other	54	56	62
Total assets	3,100	2,980	2,530
Current liabilities	357	424	228
Noncurrent liabilities	476	486	409
Total liabilities	833	910	637
Total net assets	$ 2,267	$ 2,070	$ 1,893

Over time, increases or decreases in net assets are an 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 increased total net assets approximately 10% in each of the last two years by focusing on cost controls, pursuing a long-term investment strategy to maximize risk-adjusted total returns, and appropriately utilizing 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, collateral from securities lending, 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, 2006, collateral from securities lending totaled $100 million ($183 million in 2005) and is recorded as a current asset and offsetting current liability (obligations under securities lending). The net decrease in current assets in 2006 is due primarily ($83 million) to a decrease in this collateral. This is due to a change in the makeup of the underlying investment holdings available for loan under the securities lending program as of June 30, 2006 and their related propensity for lending. The net increase in current assets in 2005 was due primarily to the new securities lending program.

Noncurrent assets:

Restricted cash and cash equivalents and restricted investments

The 2006 and 2005 balances represent unspent Series 2005 bond proceeds which are externally restricted for the construction or purchase of capital assets. The decrease in 2006 is due to the spending of these bond proceeds consistent with their restricted purpose. The increase in 2005 is due to the Series 2005 issuance in June 2005.

Endowment and other investments

At June 30, 2006 and June 30, 2005, the University's endowment investments totaled $1,061 million (an increase of $154 million) and $907 million (an increase of $161 million), respectively. During both 2006 and 2005, $60 million of investments were 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 $66 million and $77 million of the increases in 2006 and 2005, respectively, while gifts to permanent endowments totaled $19 million in both 2006 and 2005.

Other investments consist primarily of the Intermediate Term Fixed Income Fund component of the University's Operating Cash Pool, which totaled $191 million and $196 million at June 30, 2006 and 2005, respectively. Funded retirement and post-employment benefit reserves ($81 million in both 2006 and 2005) substantially account for the remainder of other investments.

For the years ended June 30, 2006, 2005, and 2004, the total returns on investments were as follows:

	2006	2005	2004
Operating Cash Pool:			
Liquidity Pool	2.3%	2.3%	0.3%
Intermediate Term Fixed Income Pool	(0.7)%	7.4%	0.8%
Common Investment Fund	13.9%	15.3%	18.7%
Other Separately Invested Investments	3.2%	5.1%	7.8%

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, 2006, 2005, and 2004, the University's investment in capital assets was as follows:

	2006	2005	2004
		(in millions)	
Land	$ 20	$ 20	$ 20
Buildings and site improvements	1,650	1,432	1,350
Construction in progress	78	138	86
Equipment and other	456	435	430
Capital assets not depreciated	6	5	5
Less: accumulated depreciation	(1,005)	(950)	(894)
	$ 1,205	$ 1,080	$ 997

Major additions to buildings and site improvements during 2006 included $62 million for the Spartan Stadium Addition, $55 million for the Diagnostic Center for Population and Animal Health, $39 million for an expansion of the T.B. Simon Power Plant, $12 million for the Veterinary Medical Center Oncology expansion, and $7 million for renovations to Kellogg Center guest rooms. 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.

Construction in progress reflects multi-year projects which, once completed and placed into service, are categorized as buildings and site improvements. The 2006 balance includes $15 million for the Grand River Parking Ramp, $8 million for Snyder-Phillips Hall renovations, and $6 million each for improvements to steam tunnel vaults and for construction of the Energy and Automotive Research Laboratories. The 2005 balance includes $50 million for the Spartan Stadium Addition, $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.

As of June 30, 2006, 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 $76 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, obligations under securities lending, deferred revenues, and other liabilities payable within one year or less. The net decrease in current liabilities in 2006 is due primarily to an $83 million reduction in obligations under securities lending due to a change in the make-up of the underlying investment holdings available for loan under the securities lending program as of June 30, 2006 and their related propensity for lending. Offsetting the net decrease in current liabilities is a $6 million increase in accounts and interest payable, due primarily to completed improvements to steam tunnel vaults ($3 million) and Snyder-Phillips Hall renovations ($2 million), and a $6 million increase in deferred revenues, due in part to sales of athletic tickets (increased $2 million, as a result of one more home football game in 2006 over 2005). The net increase in current liabilities in 2005 is due primarily to $183 million in obligations under securities lending – new in 2005. Also contributing to the net increase in current liabilities in 2005 is a $16 million increase in accounts and interest payable, due primarily to completed work on the Spartan Stadium Addition ($8 million) and an expansion of the T.B. Simon Power Plant ($5 million).

Noncurrent liabilities, primarily debt:

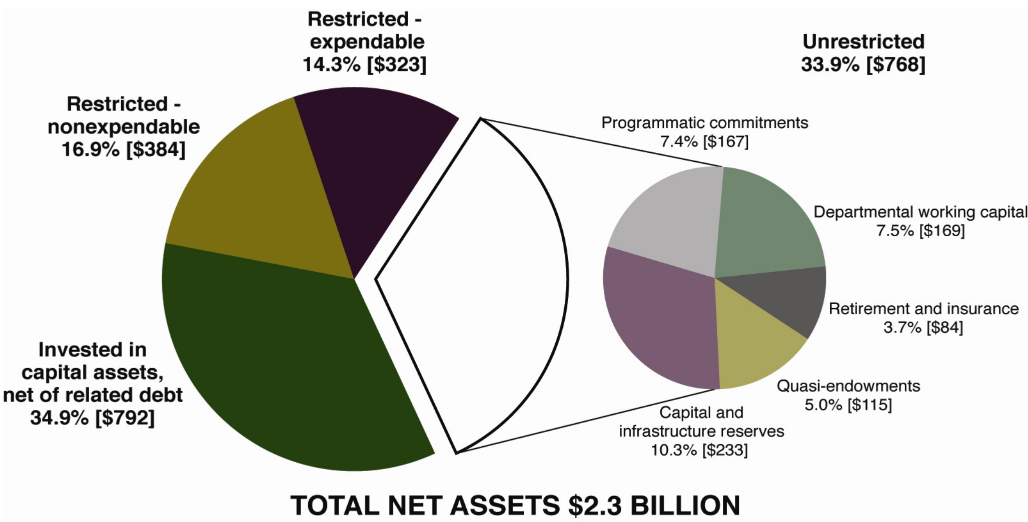
At June 30, 2006, the University had noncurrent debt and other obligations outstanding of $451 million compared with $462 million at June 30, 2005. This balance is comprised primarily of outstanding General Revenue Bonds of $413 million and $423 million in 2006 and 2005, respectively, a decrease due to principal and interest payments on existing debt, with no new debt issued in 2006. The University periodically reviews its debt capacity and related capital asset needs to optimize the use of long-term resources. The University's outstanding bonds carry an investment grade bond rating from Moody's, Standard & Poor's, and Fitch Ratings of Aa2, AA, and AA, respectively.

Net assets:

Net assets represent residual University assets after liabilities are deducted. The University's net assets at June 30, 2006, 2005, and 2004 are summarized as follows:

	2006	2005	2004
		(in millions)	
Invested in capital assets, net of related debt	$ 792	$ 711	$ 704
Restricted:			
Nonexpendable	384	333	285
Expendable	323	319	291
Total restricted	707	652	576
Unrestricted	768	707	613
Total net assets	$ 2,267	$ 2,070	$ 1,893

The following is a breakdown of net assets at June 30, 2006 (amounts are presented in millions of dollars):



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

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

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

Although unrestricted net assets are not subject to externally imposed restrictions, virtually all of the University's unrestricted net assets are designated for purposes to fulfill its various fiduciary responsibilities, including maintaining reserves for capital projects, future postemployment 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 $700 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, and to upgrade administrative and other campus-wide technology systems. 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 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 financial reporting for the unfunded accumulated benefit obligations related to postemployment healthcare and other non-pension benefits. These obligations are estimated at $776 million as of June 2006.

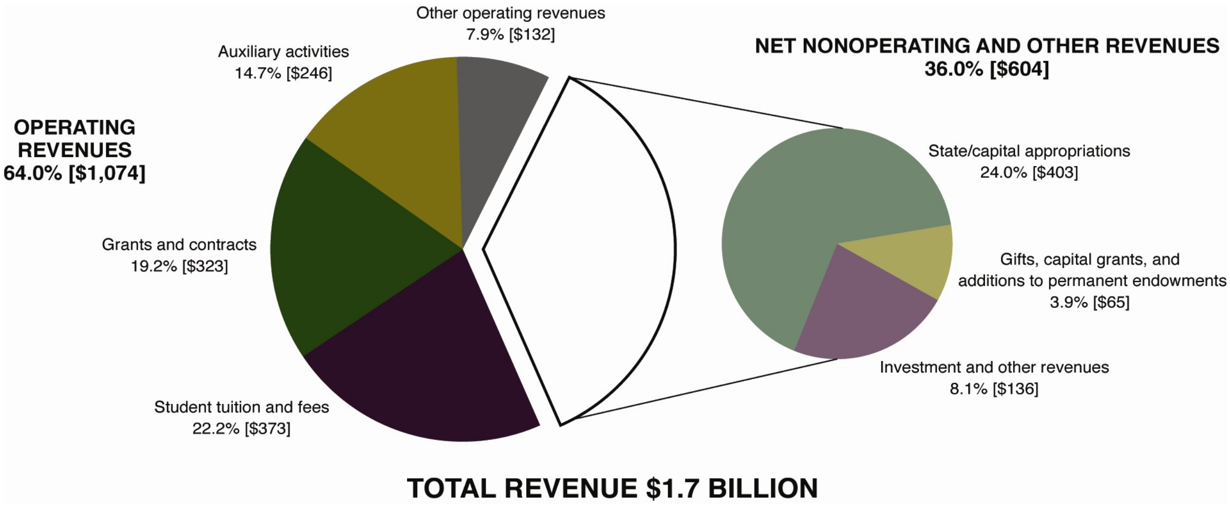
Statement of Revenues, Expenses, and Changes in Net Assets

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, 2006, 2005, and 2004 follows:

	2006	2005	2004
		(in millions)	
Operating revenues:			
Student tuition and fees, net of allowances	$ 373	$ 329	$ 308
Grants and contracts	323	320	293
Auxiliary activities	246	235	220
Other operating revenues	132	129	119
Total operating revenues	1,074	1,013	940
Operating expenses:			
Instruction and departmental research	437	420	410
Research	247	236	215
Public services	172	172	158
Academic support	68	66	60
Student services	29	25	24
Scholarships and fellowships	32	29	27
Institutional support	64	61	56
Operation and maintenance of plant	116	102	83
Auxiliary enterprises	229	208	190
Depreciation	73	65	67
Other expenses	14	4	5
Total operating expenses	1,481	1,388	1,295
Operating loss	(407)	(375)	(355)
Nonoperating revenues (expenses):			
State appropriations	348	356	341
Gifts	43	37	49
Net investment income	154	148	135
Interest expense on capital asset related debt	(16)	(13)	(12)
Other net revenues (expenses)	(2)	(1)	(1)
Net nonoperating revenues	527	527	512
Income before other revenues	120	152	157
State capital appropriations	55	-	-
Capital grants and gifts	3	6	6
Additions to permanent endowments	19	19	12
Increase in net assets	197	177	175
Net assets, beginning of year	2,070	1,893	1,718
Net assets, end of year	$ 2,267	$ 2,070	$ 1,893

The following is a graphic illustration of total net revenue by source for the year ended June 30, 2006 (amounts are presented in millions of dollars):

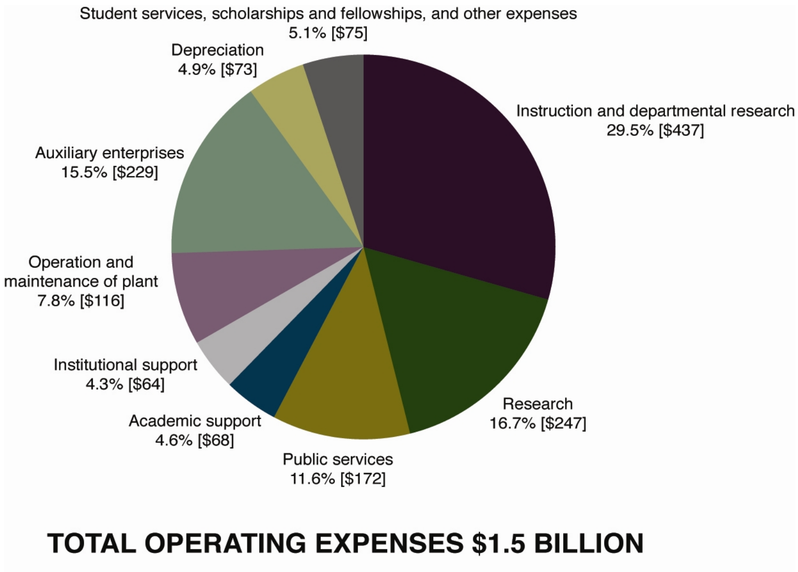


The University is supported by a diverse stream of revenue which supplements its student tuition and fees, including state appropriations, federal and state sponsored programs, private gifts and grants, and investment income. The University continues to seek funding from all possible sources consistent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

Operating revenues: The most significant source of operating revenue for the University is tuition and fees (net of scholarship allowances), totaling $373 million and $329 million in 2006 and 2005, respectively. Gross tuition and fees revenue increased 13.6% in 2006 which includes an 11.6% effective rate increase in tuition and fees and a 2.0% revenue increase from additional student credit hours taken and changes in the student blend. The 6.3% increase in 2005 reflects a 4.3% effective rate increase in tuition and fees and a 2.0% revenue increase from additional student credit hours taken and changes in the student blend. Other major revenue sources in 2006 include federal grants and contracts of $247 million (an increase of $16 million), including $188 million for sponsored research programs, and auxiliary services of $246 million (an increase of $11 million).

Net nonoperating and other revenues: The primary source of this net revenue is State appropriations, which totaled $348 million in 2006, a decrease of $8 million (2.3%). For 2006, $284 million in funding for general operations was appropriated. In addition, the State restored $2 million of 2005 Executive Order budget cuts. For 2005, $287 million in funding for general operations was appropriated, but subsequently reduced a net $2 million. Additionally, in 2005 the State allocated one-time general operations funding of $9 million to refund a portion of 2004 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 2006, other significant components of net nonoperating revenues include state capital appropriations (increased $55 million due to the State's appropriation of the Diagnostic Center for Population and Animal Health building to MSU), gift revenue (increased $6 million), and net investment income (increased $6 million). In 2005, MSU received no State capital appropriations, and gift revenue and net investment income decreased $12 million and increased $13 million, respectively.

The following is a graphic illustration of operating expenses by source for the year ended June 30, 2006 (amounts are presented in millions of dollars):



During 2006, $856 million was expended for the core missions of the University, instruction and departmental research, research, and public services, an increase of $28 million (3.4%) over 2005. Total instruction and departmental research expenses increased $16 million (3.8%), primarily due to faculty/staff salary increases, which averaged 2.6%, and targeted funding to enhance academic programs. The $11 million (4.7%) increase in research expenses reflects continued growth in sponsored research programs, while public service expenses remained consistent with 2005 levels. Auxiliary enterprises (activities which provide services to students, faculty, staff, and the public) increased $21 million (10.1%), due in part to increases in residence hall and apartment expenses, up 4.7% to $86 million, and intercollegiate athletics activities, up 10.8% to $43 million. Expenses for the operation and maintenance of plant increased $14 million (13.7%), primarily due to increased energy costs.

Economic Outlook

The University's revenue mix is closely associated with the level of State support. As such, there is a direct relationship between the growth of State appropriations and the increase in the University's tuition and fee levels. Static or declining State appropriations generally result in increased tuition and fees. Due to economic pressures affecting the State of Michigan, 2006-07 fiscal year budgeted State appropriations will be only 3.0% higher than 2005-06 levels. As a result, the Board of Trustees approved a 5.9% increase for fall 2006 in-state undergraduate tuition and required fees. Sustained adverse economic pressures affecting the State will likely continue to 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 $1.20 billion by 2007. As of June 30, 2006, $1.17 billion had been raised in cash, in-kind gifts, pledges, irrevocable life income agreements, and bequests.

plante moran

Plante & Moran, PLLC
Suite 300
750 Trade Centre Way
Portage, MI 49002
Tel: 269.567.4500
Fax: 269.567.4501
plantemoran.com

Independent Auditor's Report

To the Board of Trustees
Michigan State University

We have audited the accompanying balance sheet of Michigan State University (the University) as of June 30, 2006 and the related statements of revenue, expenses, and changes in net assets and cash flows for the year then ended. 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. The financial statements of Michigan State University as of June 30, 2005 were audited by other auditors, whose report dated September 30, 2005 expressed an unqualified opinion on those statements. 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 *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Michigan State University as of June 30, 2006 and the results of its operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 22, 2006 on our consideration of Michigan State University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters for year ended June 30, 2006. 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 opinions on the 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.

The management's discussion and analysis presented on pages 1 through 9 is not a required part of the basic financial statements but is supplemental information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management, regarding the methods of measurement and presentation of the supplemental information. However, we did not audit the information and express no opinion on it.

Plante & Moran, PLLC

Kalamazoo, Michigan
September 22, 2006

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STATEMENTS OF NET ASSETS
Michigan State University

	June 30, 2006	June 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,972,529	$ 14,240,530
Investments	167,486,791	177,087,569
Collateral from securities lending	100,221,019	182,889,036
Accounts and interest receivable, net	120,488,167	127,528,955
Student loans receivable, net	27,001,361	23,947,020
Pledges receivable, net	10,032,869	12,238,063
Inventories and other assets	14,964,492	12,403,409
Total current assets	450,167,228	550,334,582
Noncurrent assets:		
Restricted cash and cash equivalents	10,281,855	16,573,585
Restricted investments	18,310,022	66,080,730
Endowment investments	1,060,977,430	906,778,971
Other investments	301,752,727	303,755,933
Student loans receivable, net	29,405,921	28,692,922
Pledges receivable, net	13,869,366	16,078,348
Investments in joint ventures	6,179,024	6,619,604
Unamortized bond origination costs	4,180,330	4,368,646
Capital assets, net	1,204,773,700	1,080,481,483
Total noncurrent assets	2,649,730,375	2,429,430,222
TOTAL ASSETS	**$ 3,099,897,603**	**$ 2,979,764,804**
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts and interest payable	$ 53,809,366	$ 47,738,628
Accrued personnel costs	50,644,822	49,461,334
Obligations under securities lending	100,221,019	182,889,036
Accrued self-insurance liabilities	11,065,517	13,454,445
Payroll taxes and other payroll deductions	29,087,043	31,256,591
Deposits held for others	20,004,021	18,389,029
Deferred revenues	64,470,075	58,221,639
Current portion of long term debt and other obligations	27,395,007	22,402,092
Total current liabilities	356,696,870	423,812,794
Noncurrent liabilities:		
Accrued personnel costs	17,367,127	17,540,964
Accrued self-insurance liabilities	7,763,606	6,512,375
Long term debt and other obligations	450,751,902	461,620,721
Total noncurrent liabilities	475,882,635	485,674,060
Total liabilities	**832,579,505**	**909,486,854**
Net assets:		
Invested in capital assets, net of related debt	791,876,221	710,770,232
Restricted:		
Nonexpendable	383,851,741	332,554,686
Expendable	323,620,467	319,354,601
Unrestricted	767,969,669	707,598,431
Total net assets	**2,267,318,098**	**2,070,277,950**
TOTAL LIABILITIES AND NET ASSETS	**$ 3,099,897,603**	**$ 2,979,764,804**

See accompanying notes

STATEMENTS OF FINANCIAL POSITION

Michigan State University Foundation

	June 30, 2006	June 30, 2005
ASSETS		
Cash equivalents	$ 4,692,189	$ 10,610,579
Interest and dividends receivable	141,447	98,890
Grants and contracts receivable - Net	1,691,618	-
Notes receivable	-	3,639,877
Other receivables	953,383	1,271,022
Investments:		
Marketable securities	243,295,872	236,368,052
Investments in limited partnerships	73,787,837	66,052,741
Venture capital	20,804,444	16,490,400
Cash value of life insurance	1,517,774	1,494,098
Land held for investment	2,755,333	2,755,333
Other investments	1,197,012	946,000
Investment in IP Ventures LLC	524,841	579,518
Investment in Research Park	3,345,382	3,348,658
Prepaid expenses	54,928	55,247
Property and equipment, net	7,590,384	4,213
Intangible assets - Net	881,332	-
Other assets	11,185	-
TOTAL ASSETS	**$ 363,244,961**	**$ 343,714,628**
LIABILITIES AND NET ASSETS		
Liabilities:		
Accounts payable	$ -	$ 208,447
Accrued expenses and other payables	2,323,453	1,059,340
Note payable	-	15,250,000
Line of credit	-	-
Deferred compensation	525,224	-
Note payable - deferred compensation	195,955	-
Trusts and annuities payable	7,785,818	6,634,398
Deferred gifts	433,000	433,000
Obligations under life estate agreements	85,723	109,650
Total liabilities	**11,349,173**	**23,694,835**
Net assets:		
Unrestricted	323,249,848	293,732,218
Temporarily restricted	15,519,675	14,221,999
Permanently restricted	13,126,265	12,065,576
Total net assets	**351,895,788**	**320,019,793**
TOTAL LIABILITIES AND NET ASSETS	**$ 363,244,961**	**$ 343,714,628**

See accompanying notes

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

	Year ended June 30, 2006	Year ended June 30, 2005
OPERATING REVENUES		
Student tuition and fees	$ 423,963,188	$ 373,307,566
Less: scholarship allowances	51,236,303	44,007,144
Net student tuition and fees	372,726,885	329,300,422
State of Michigan grants and contracts	26,542,292	39,460,126
Federal grants and contracts	247,074,159	231,108,854
Local and private sponsored programs	49,307,513	49,011,971
Interest and fees on student loans	3,307,598	1,691,083
Departmental activities (net of scholarship allowances of $3,535,000 in 2006 and $2,677,000 in 2005)	129,185,721	127,118,487
Auxiliary activities (net of room and board allowances of $10,055,000 in 2006 and $7,724,000 in 2005)	245,520,697	235,324,557
TOTAL OPERATING REVENUES	**1,073,664,865**	**1,013,015,500**
OPERATING EXPENSES		
Instruction and departmental research	436,577,735	420,424,908
Research	247,061,028	235,980,709
Public services	171,944,153	171,812,259
Academic support	68,140,338	66,404,059
Student services	28,632,807	24,597,372
Scholarships and fellowships	32,490,277	28,814,667
Institutional support	64,501,345	60,919,671
Operation and maintenance of plant	115,654,209	102,358,145
Auxiliary enterprises	229,264,212	207,766,572
Depreciation	73,036,977	64,635,686
Other expenses	13,767,348	3,862,627
TOTAL OPERATING EXPENSES	**1,481,070,429**	**1,387,576,675**
Operating loss	(407,405,564)	(374,561,175)
NONOPERATING REVENUES (EXPENSES)		
State of Michigan appropriations	347,770,500	355,813,500
Gifts	42,827,303	36,657,827
Net investment income	154,125,789	148,071,543
Interest expense on capital asset related debt	(15,740,613)	(12,903,993)
Other expenses	(1,833,244)	(1,159,718)
Net nonoperating revenues	527,149,735	526,479,159
INCOME BEFORE OTHER REVENUES	**119,744,171**	**151,917,984**
State capital appropriations	55,161,399	-
Capital grants and gifts	2,928,454	5,778,879
Additions to permanent endowments	19,206,124	19,301,488
Increase in net assets	197,040,148	176,998,351
Net assets, beginning of year	2,070,277,950	1,893,279,599
NET ASSETS, END OF YEAR	**$ 2,267,318,098**	**$ 2,070,277,950**

See accompanying notes

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

Year ended June 30, 2006

	Unrestricted Funds	Temporarily Restricted	Permanently Restricted	Total
REVENUE, GAINS AND OTHER SUPPORT:				
Contributions	$ 49,047	$ 2,947,693	$ 222,123	$ 3,218,863
Equity earnings - subsidiaries	112,848			112,848
Income from investments	16,600,324	151,965	546,217	17,298,506
Royalty income	468,200			468,200
Realized gain on sale of securities	17,200,605	1,407,855	876,389	19,484,849
Unrealized gain (loss) on securities	8,462,703	(863,839)	(635,883)	6,962,981
Grants and contracts	5,805,648			5,805,648
Other income	1,140,842			1,140,842
Net assets released from restrictions:				
Satisfaction of program restrictions	37,724	(33,130)	(4,594)	-
Current year transfers	2,773,431	(2,312,868)	(460,563)	-
TOTAL REVENUE, GAINS AND OTHER SUPPORT	52,651,372	1,297,676	543,689	54,492,737
EXPENSES:				
Salaries, wages, and benefits	3,083,393			3,083,393
Contributions to the University	16,233,778			16,233,778
Patent expense	950,086			950,086
Investment management fees	1,338,214			1,338,214
Management and general	4,960,749			4,960,749
Postemployment retirement benefits	80,000			80,000
Operational expenses - Management Company	60,610			60,610
Research contracts	266,657			266,657
TOTAL EXPENSES	26,973,487	-	-	26,973,487
Increase in net assets	25,677,885	1,297,676	543,689	27,519,250
Net assets, beginning of year	298,088,963	14,221,999	12,065,576	324,376,538
NET ASSETS, END OF YEAR	$ 323,766,848	$ 15,519,675	$ 12,609,265	$ 351,895,788

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

See accompanying notes

STATEMENTS OF CASH FLOWS
Michigan State University

	Year ended June 30, 2006	2005
Cash flows from operating activities		
Tuition and fees	$ 374,024,051	$ 329,643,589
Research grants and contracts	331,717,968	312,448,939
Auxiliary activities	248,764,194	238,054,500
Departmental activities	129,957,937	127,230,506
Interest and fees on student loans	3,307,598	1,691,083
Loans issued to students	(98,389,269)	(87,067,458)
Collection of loans from students	94,621,929	86,039,554
Scholarships and fellowships	(19,221,769)	(32,842,448)
Payments to suppliers	(385,688,853)	(338,765,159)
Payments to employees	(981,417,065)	(920,816,254)
Other payments	(22,384,249)	(34,168,517)
Net cash provided (used) by operating activities	(324,707,528)	(318,551,665)
Cash flows from noncapital financing activities		
State appropriations	345,717,361	355,485,171
Gifts	43,997,085	40,296,513
Endowment gifts	19,468,359	18,969,545
Federal Family Education Loan Program receipts	230,542,731	211,538,994
Federal Family Education Loan Program disbursements	(227,430,721)	(210,256,097)
Net cash provided (used) by noncapital financing activities	412,294,815	416,034,126
Cash flows from capital and related financing activities		
Capital appropriations	(160,576)	1,127,694
Capital gifts and grants	5,910,613	8,805,319
Proceeds from issuance of debt and other long term obligations	-	85,855,000
Purchase of capital assets	(142,852,364)	(141,923,358)
Proceeds from sale of capital assets	753,208	627,077
Principal paid on capital debt	(8,987,914)	(4,273,049)
Interest paid	(15,867,745)	(12,952,337)
Other receipts (payments)	2,229,765	1,934,699
Net cash provided (used) by capital and related financing activities	(158,975,013)	(60,798,955)
Cash flows from investing activities		
Investment income, net	109,903,558	102,531,931
Proceeds from sales and maturities of investments	21,812,918,770	23,365,639,305
Purchase of investments	(21,861,994,333)	(23,508,160,830)
Net cash provided (used) by investing activities	60,827,995	(39,989,594)
Net decrease in cash	(10,559,731)	(3,306,088)
Cash and cash equivalents, beginning of year	30,814,115	34,120,203
Cash and cash equivalents, end of year	$ 20,254,384	$ 30,814,115

See accompanying notes

Reconciliation of net operating loss to cash flows from operating activities:	Year ended June 30, 2006	2005
Operating loss	$ (407,405,564)	$ (374,561,175)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation expense	73,036,977	64,635,686
Change in assets and liabilities:		
Accounts receivable	9,326,128	(4,064,313)
Student loans receivable	(3,767,340)	(1,027,904)
Inventories and other assets	(2,561,083)	207,410
Investments in joint ventures	440,580	(504,304)
Unamortized bond origination costs	188,316	(12,690)
Accounts payable	468,624	5,986,712
Accrued personnel costs	1,009,651	1,952,501
Payroll taxes and other payroll deductions	(2,169,548)	529,327
Deposits held for others	1,614,992	(7,384,851)
Deferred revenues	6,248,436	(5,516,590)
Accrued self-insurance liabilities	(1,137,697)	1,208,526
Net cash provided (used) by operating activities	$ (324,707,528)	$ (318,551,665)

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 its 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 financial information included in the University's financial report to account 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 – 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 in these funds at the date of the financial statements are due to timing of reinvesting the proceeds within the fund.

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 certain 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 that 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% 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, 2006 and 2005 were as follows:

	2006	2005
Cash and cash equivalents, current	$ 9,972	$ 14,240
Restricted cash and cash equivalents, noncurrent	10,282	16,574
Total cash and cash equivalents	$ 20,254	$ 30,814

Of the bank balances for cash, $100 of the total $2,955 in 2006 and $100 of the total $4,889 in 2005 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. 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 University participates in a Board-authorized 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 $96,902 and $178,400 at June 30, 2006 and 2005, respectively. One of the University's custodians is an agent in lending the University's domestic securities for cash collateral of 102% and international securities for cash collateral of 105%. At June 30, 2006 and 2005, the University had no credit risk exposure to borrowers because the amounts the University owed the borrowers exceed the amounts the borrowers owed 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, 2006 and 2005, the difference was less than 90 days.

As of June 30, 2006 and 2005, the University had the following investments:

	June 30, 2006					
Investment type	LP	IT	CIF	Securities Lending	Other	Total
Repurchase agreements	$ -	$ -	$ -	$ 45,221	$ -	$ 45,221
External investment pools	13,511	190,762	772,056	-	19,855	996,184
U.S. Treasury bonds	-	-	13,823	-	60	13,883
U.S. Government agencies	30,245	-	83,027	-	77	113,349
Corporate bonds	52,300	-	36,602	55,000	272	144,174
Asset-backed securities	89,741	-	40,671	-	-	130,412
Domestic common stock	-	-	190,488	-	1,393	191,881
Domestic convertible preferred stock	-	-	-	-	-	-
International equities	-	-	13,604	-	40	13,644
Total	$ 185,797	$ 190,762	$ 1,150,271	$ 100,221	$ 21,697	$ 1,648,748

	June 30, 2005					
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, 2006 and 2005, the University was 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, 2006 and 2005 are as follows:

June 30, 2006
Fixed Income Investment Maturities

Investment type	Less than 1 year	1-5 years	6-10 years	More than 10 years	Total
Repurchase agreements	$ 45,221	$ -	$ -	$ -	$ 45,221
External investment pools	3,323	452	191,436	1,423	196,634
U.S. Treasury bonds	-	1,623	785	11,475	13,883
U.S. Government agencies	13,256	4,793	8,723	86,500	113,272
Corporate bonds	41,659	78,697	15,061	8,757	144,174
Asset-backed securities	650	54,356	7,498	67,908	130,412
Total	$ 104,109	$ 139,921	$ 223,503	$ 176,063	$ 643,596

June 30, 2005
Fixed Income Investment Maturities

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, 2006 and 2005, the University was 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, 2006 and 2005 are as follows:

As of June 30, 2006

Rating	Repurchase agreements	External investment pools	U.S. Treasury bonds	U.S. Government agencies	Corporate bonds	Asset-backed securities	Total
AAA	$ -	$ -	$ -	$ 16,537	$ 18,454	$ 111,499	$ 146,490
AA	22,221	-	-	-	26,252	94	48,567
A	23,000	322	-	-	64,438	306	88,066
BBB	-	-	-	-	31,243	502	31,745
BB	-	-	-	-	2,261	531	2,792
Below BB	-	-	-	-	-	-	-
Not rated	-	196,312	13,883	96,735	1,526	17,480	325,936
Total	$ 45,221	$ 196,634	$ 13,883	$ 113,272	$ 144,174	$ 130,412	$ 643,596

As of June 30, 2005

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
AA	34,067	-	-	-	29,693	-	63,760
A	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% 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% 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% of the portfolio's market value may be invested in securities below BBB. No more than 30% of the portfolio's market value may be invested in securities denominated in foreign currencies. No more than 10% 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 established at time of manager appointment.

As of June 30, 2006 and 2005, not more than 5% 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, $115 of the U.S. Treasury bonds, $101,102 of the U.S. Government agencies, $87,905 of the Corporate bonds, $130,411 of the Asset-backed securities, $124,557 of the domestic equities, $7,799 of the international equities, and $31,686 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, $100,221 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, 2006 and 2005 are summarized as follows:

	2006		2005	
	Cost	Market	Cost	Market
Short-term investments	$ 1,191	$ 1,191	$ 14,211	$ 14,211
Domestic equities	50,552	60,183	38,883	44,927
Foreign equities	63,427	74,758	54,589	61,610
Other equities	787	972	784	822
Fixed income	61,611	60,352	46,096	47,546
Mutual funds – Equities	27,913	29,915	47,419	52,488
Mutual funds – Fixed	16,403	15,925	14,528	14,764
Limited partnerships	60,707	73,788	58,177	66,053
	$ 282,591	$ 317,084	$ 274,687	$ 302,421

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, 2006 and 2005 is summarized as follows:

	2006	2005
State operating appropriations	$ 63,287	$ 61,234
Research and sponsored programs	38,569	45,527
Departmental activities	16,108	17,376
Interest receivable	3,043	2,972
Other	9,183	9,002
	130,190	136,111
Less: allowance for doubtful accounts	9,702	8,582
Net accounts and interest receivable	$ 120,488	$ 127,529

6. Student loans receivable

Student loans receivable at June 30, 2006 and 2005 are summarized as follows:

Description	2005	Distributed	Collected	2006	Current Portion
Federal Family Education Loan Program	$ 12,544	$ 84,419	$ 81,902	$ 15,061	$ 15,061
Perkins Federal Loan Program	34,997	8,398	7,460	35,935	9,333
Other	9,099	5,572	5,160	9,511	2,787
	56,640	$ 98,389	$ 94,522	60,507	27,181
Allowance for uncollectible loans	(4,000)			(4,100)	(180)
Net student loan receivable	$ 52,640			$ 56,407	$ 27,001

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

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, 2006, the University distributed $124,418 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, 2006, 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%.

2007	$ 11,219
2008	4,587
2009	3,079
2010	2,427
2011	1,747
2012 and beyond	3,642
Total discounted pledges receivable	26,701
Less: allowance for uncollectible pledges	2,799
Net pledges receivable, June 30, 2006	23,902
Less: current portion	10,033
Noncurrent portion	$ 13,869

8. Long term debt and other obligations

Long term debt and other obligations for the years ended June 30, 2006 and 2005 are summarized as follows:

	2005	Borrowed	Retired	2006	Current Portion
General Revenue Bonds:					
Series 2005	$ 84,580	$ -	$ -	$ 84,580	$ -
Series 2003A	80,570		1,735	78,835	1,730
Series 2003B	23,540	-	160	23,380	820
Series 2003C	10,850	-	180	10,670	190
Series 2002A	53,780	-	2,135	51,645	2,440
Series 2002B	11,480	-	1,075	10,405	1,115
Series 2000A	104,950	-	760	104,190	1,240
Series 1998A-2	51,935	-	-	51,935	-
Series 1998A-1	9,525	-	2,220	7,305	2,320
Series 1996A	625	-	625	-	-
	431,835	-	8,890	422,945	9,855
Federal student loan deposits	34,483	1,047	184	35,346	-
Short term line of credit	13,914	104,029	101,780	16,163	16,163
Lease Obligations	3,791	-	98	3,693	1,377
	$ 484,023	$ 105,076	$ 110,952	$ 478,147	$ 27,395

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

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: from fiscal 2006 through 2033
- Series 2003B: from fiscal 2006 through 2026
- Series 2002A: from fiscal 2005 through 2032
- Series 2002B: from fiscal 2005 through 2022
- Series 2000A: from fiscal 2005 through 2030
- Series 1998A-1: from fiscal 2005 through 2008

- Series 1998A-2: from fiscal 2009 through 2022

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 4.30% to 5.00% and mature serially through fiscal 2008.

The Series 1996A bonds paid interest at a rate of 4.65% through February 15, 2006, their final maturity date.

Interest expense was $15,741 and $12,904 for 2006 and 2005, respectively.

Swap payments and associated debt: Using rates as of June 30, 2006, 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
2007	2,320	$ 262	$ 7,535	$ 16,553	$ 1,137	$ 27,807
2008	2,430	143	9,725	16,197	1,136	29,631
2009	2,555	16	10,050	15,785	1,132	29,538
2010	-	-	13,085	15,264	1,114	29,463
2011	-	-	11,385	14,799	1,085	27,269
2012-2016	-	-	63,985	66,537	4,926	135,448
2017-2021	-	-	77,755	52,186	3,916	133,857
2022-2026	-	-	90,430	35,020	2,528	127,978
2027-2031	-	-	93,345	16,458	814	110,617
2032-2034	-	-	38,345	1,556	42	39,943
Total	$ 7,305	$ 421	$ 415,640	$ 250,355	$ 17,830	$ 691,551

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

At June 30, 2006, the University owed $16,163 on a short term $82,500 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, 2006 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 2006 and 2005 were as follows:

	2006	2005
Balance, beginning of year	$ 67,002	$ 65,050
Additions	2,594	4,149
Reductions	(1,584)	(2,197)
Balance, end of year	68,012	67,002
Less: current portion	50,645	49,461
Noncurrent portion	$ 17,367	$ 17,541

9. Retirement benefits

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

Participating employees contribute 5% of their base salary or wages and the University contributes 10% of the employee's base salary or wages subject to applicable Internal Revenue Service limits. Participants may elect to contribute additional amounts to a supplemental plan 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, 2006 and 2005 were as follows:

	2006	2005
University contributions	$ 53,252	$ 51,841
Employee contributions	26,626	25,921

In addition, the University has a single-employer, defined benefit plan covering 975 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, 2006.

10. Other postemployment 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 3,900 in 2006 and 3,800 in 2005. The University recognizes the cost of providing those benefits on a pay-as-you-go basis. Those costs totaled $23,168 for 2006 and $23,243 for 2005 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, 2006, 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 $76,017 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 certain 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, 2006, 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, 2006, $105,376 of the initial $193,550 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 $6,115 as of June 30, 2006. The discount rate used was 5%.

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 $3,420 as of June 30, 2006. The discount rate used was 6%.

Changes in the total reported general, professional, and self-insured employee benefit liabilities during 2006, 2005, and 2004 were as follows:

	2006	2005	2004
Balance, beginning of year	$ 19,967	$ 18,758	$ 17,354
Claims incurred and changes in estimates	84,923	90,433	82,719
Claim payments	(86,061)	(89,224)	(81,315)
Balance, end of year	18,829	19,967	18,758
Less: current portion	11,065	13,455	12,005
Noncurrent portion	$ 7,764	$ 6,512	$ 6,753

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 nonprofit 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% member in each of the foregoing nonprofit corporations. Additionally, the University is a 33% member in Radiation Oncology Alliance, a nonprofit 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, 2006 and 2005 follows:

	2005	Additions (Deductions)	Disposals	2006
Non-depreciated capital assets:				
Land	$ 19,517	$ -	$ -	$ 19,517
Construction in progress	138,364	(60,699)	-	77,665
Museum Collections	5,404	473	-	5,877
Total non-depreciated capital assets	163,285	(60,226)	-	103,059
Depreciated capital assets:				
Buildings and site improvements	1,432,040	226,935	(8,572)	1,650,403
Equipment and other	434,738	35,436	(14,109)	456,065
Less: accumulated depreciation				
Buildings and site improvements	(612,157)	(43,396)	5,359	(650,194)
Equipment and other	(337,425)	(29,640)	12,506	(354,559)
Total depreciated capital assets	917,196	189,335	(4,816)	1,101,715
Total capital assets	$ 1,080,481	$ 129,109	$ (4,816)	$ 1,204,774

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

16. Net assets

Restricted and unrestricted net assets for the years ended June 30, 2006 and 2005 are as follows:

	2006	2005
Restricted - nonexpendable:		
Permanent endowments	$ 383,852	$ 332,555
Restricted - expendable:		
Gifts, endowment income and sponsored programs	$ 164,072	$ 170,319
Quasi and term endowments	139,218	125,446
Capital projects	12,809	16,124
Student loans	7,521	7,466
Total	$ 323,620	$ 319,355
Unrestricted:		
Designated	$ 767,654	$ 706,911
Uncommitted	316	687
Total	$ 767,970	$ 707,598

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 not reported at fair value on the Statement of Net Assets at June 30, 2006.

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. In order to benefit from expected changes in the relationship of short and long-term interest rates, the University also entered into two separate pay-variable receive-variable interest rate swaps which relate to eight of the ten pay-fixed, receive-variable interest rate swaps.

Terms, fair values, and credit risk: The terms, fair values, and credit rating of the outstanding swaps as of June 30, 2006 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	Rate Paid	Rate Received	Fair Value	Swap Termination Date	Counterparty/ Counterparty Credit Rating
1998A-2	$ 51,935	7/1/1998	4.604%	BMA Municipal Swap Index	$ (3,788)	8/15/2022	Ambac Financial Services/Aaa
2000A-1 & 2000A-2	98,285	5/2/2002	4.074%	67% USD-LIBOR-BBA one month	(3,198)	8/15/2029	Lehman Brothers Special Financing Inc./A1
2002A	49,525	10/17/2002	3.390%	67% USD-LIBOR-BBA one month	1,442	8/15/2032	UBS AG/Aa2
2002A	2,120	10/17/2002	3.530%	67% USD-LIBOR-BBA one month	49	8/15/2022	UBS AG/Aa2
2002B	8,365	10/17/2002	4.330%	USD-LIBOR-BBA one month	319	8/15/2018	UBS AG/Aa2
2002B	2,040	10/17/2002	5.280%	USD-LIBOR-BBA one month	68	8/15/2022	UBS AG/Aa2
2003A	78,835	12/11/2003	3.618%	67% USD-LIBOR-BBA one month	1,090	2/15/2033	Lehman Brothers Special Financing Inc./A1
2003B	23,380	12/11/2003	3.479%	67% USD-LIBOR-BBA one month	444	2/15/2026	UBS AG/Aa2
2003C	10,670	12/11/2003	5.330%	USD-LIBOR-BBA one month	309	2/15/2033	Lehman Brothers Special Financing Inc./A1
2005	84,580	7/2/2007	3.647%	67% USD-LIBOR-BBA one month	1,743	2/15/2034	Lehman Brothers Special Financing Inc./A1
2000A-1, 2000A-2, 2002A, 2003A, & 2005	313,345	5/26/2006	67% USD-LIBOR-BBA one month	67% USD-LIBOR-BBA ten year less .407%	(2,771)	2/15/2034	UBS AG/Aa2
2002B & 2003C	21,075	5/26/2006	USD-LIBOR-BBA one month	USD-LIBOR-BBA ten year less .575%	(190)	2/15/2034	UBS AG/Aa2
Total	$ 744,155				$ (4,483)		

Fair Value: Primarily because interest rates have declined since their execution, the pay-fixed receive-variable swaps in total have a negative fair value as of June 30, 2006. 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. Primarily because of initial market placement costs and narrowing interest rate spreads between one month LIBOR maturities and ten year LIBOR maturities since the execution of the swaps, both of the pay-variable receive-variable swaps have negative fair values as of June 30, 2006. 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, seven swaps, approximating 56% of the notional amount of swaps outstanding, are with UBS AG, which is rated Aa2. Of the remaining swaps, the University holds four agreements with Lehman Brothers Special Financing, Inc, rated A1, making up approximately 37% of the outstanding notional value. The remaining swap is with AMBAC Financial Services, rated Aaa.

As of June 30, 2006, (1) the University's credit ratings were Aa2 as assigned by Moody's, and AA as assigned by Standard & Poor's and Fitch Ratings, and (2) the University was exposed to credit risk in the amount of $3,142 related to the pay-fixed, receive-variable interest rate swaps with Lehman Brothers Special Financing, Inc. associated with the 2003A, 2003C and 2005 bond issues. To mitigate credit risk, if the counterparties' credit quality falls below certain levels, collateralization is required. The following table demonstrates the thresholds and minimum transfers for collateralization:

					Lehman Brothers Special Financing, Inc.			
	AMBAC		UBS Warburg		Series 2000A*		Series 2003A & C, 2005	
Credit Rating	Threshold	Minimum Transfer	Threshold	Minimum Transfer	Threshold	Minimum Transfer	Threshold	Minimum Transfer
Aaa/AAA	Unlimited	N/A	$ 40,000	$ 1,000	$ 1,000	$ 100	$ 40,000	$ 1,000
Aa3/AA- to Aa1/AA+	$ 6,000	$ 1,000	6,000	1,000	1,000	100	6,000	1,000
A3/A- to A1/A+	1,500	500	1,500	500	1,000	100	1,500	500
Above Baa2/BBB- up to Baa1/BBB+	500	250	500	250	1,000	100	500	250
Baa2/BBB	500	250	500	250	500	100	500	250
Below Baa2/BBB	-	250	-	250	-	100	-	250

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

Basis Risk: The pay-fixed receive-variable swaps expose the University to basis risk should the rates resulting from the BMA swap index for the 1998A-2 swap, 67% 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. The pay-variable receive-variable swaps expose the University to basis risk should interest rate spreads between one month LIBOR maturities and ten year LIBOR maturities narrow.

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. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, effective with the fiscal year ending June 30, 2008. While the University has not yet determined the full impact of GASB Statement No. 45 on its financial statements, in accordance with this Statement, the University will address the accounting and financial reporting for the unfunded accumulated benefit obligations related to postemployment healthcare and other non-pension benefits. These obligations are estimated at $776 million as of June 30, 2006.

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, Assistant Controller; Gregory J. Deppong, Chief Accountant; and Robert J. Patterson, Manager of Financial Analysis.

Plante & Moran, PLLC
Suite 300
750 Trade Centre Way
Portage, MI 49002
Tel: 269.567.4500
Fax: 269.567.4501
plantemoran.com

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*

To the Board of Trustees
Michigan State University

We have audited the basic financial statements of Michigan State University as of and for the year ended June 30, 2006, and have issued our report thereon dated September 22, 2006. 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Michigan State University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide 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 over financial reporting 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 Michigan State 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 finance and audit committee, the Board of Trustees and management, and is not intended to be and should not be used by anyone other than these specified parties.

Plante & Moran, PLLC

Kalamazoo, Michigan
September 22, 2006

Boldness by Design: Strategic positioning of Michigan State University for national and international leadership as the premier land-grant university for the 21st century