Management's Discussion and Analysis (UNAUDITED)

Introduction

The following discussion and analysis provides an overview of the financial position of The University of Michigan (the "University") at June 30, 2005 and 2004 and its activities for the three fiscal years ended June 30, 2005. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

The University is a comprehensive public institution of higher learning with approximately 54,000 students and 5,600 faculty members on three campuses in southeast Michigan. The University offers a diverse range of degree programs from baccalaureate to post-doctoral levels, through a framework of 139 departmental units in 19 schools, colleges and divisions, and contributes to the state and nation through related research and public service programs. The University, in total, employs more than 46,000 permanent and temporary staff. The University also maintains one of the largest health care complexes in the world through its Hospitals and Health Centers (the "HHC"). HHC consists of three hospitals, 30 health centers and more than 120 outpatient clinics. HHC is an integral part of the University's Health System which also includes the University's Medical School; Michigan Health Corporation, a wholly-owned corporation created to pursue joint venture and managed care initiatives; and M-CARE, a wholly-owned health maintenance organization.

The University consistently ranks among the nation's top universities by various measures of quality, both in general academic terms, and in terms of strength of offerings in specific academic disciplines and professional subjects. Excellence in research is another crucial element in the University's high ranking among educational institutions. Research is central to the University's mission and permeates its schools and colleges. In addition to the large volume of research conducted within the academic schools, colleges, and departments, the University has more than a dozen large-scale research institutes outside the academic units that conduct, in collaboration with those units, full-time research focused on long-term interdisciplinary matters. The University's Health System also has a tradition of excellence in teaching, advancement of medical science and patient care, consistently ranking among the best health care systems in the nation.

Financial Highlights

The University's financial position remains strong, with assets of $10.8 billion and liabilities of $2.0 billion at June 30, 2005, compared to assets of $9.5 billion and liabilities of $1.8 billion at June 30, 2004. Net assets, which represent the residual interest in the University's assets after liabilities are deducted, increased $1.1 billion in fiscal 2005, to $8.8 billion at June 30, 2005. Changes in net assets represent the University's results of operations and are summarized for the years ended June 30, 2005 and 2004 as follows:

	2005	2004
	(in millions)	
Operating revenues and state educational appropriations	$ 3,935.6	$ 3,740.7
Total expenses	4,047.8	3,902.1
	(112.2)	(161.4)
Net investment income	874.6	714.6
Gifts and other nonoperating revenues	318.0	216.5
Increase in net assets	$ 1,080.4	$ 769.7

Net assets increased $1.1 billion in 2005 and increased $770 million in 2004. The $311 million improvement between 2005 and 2004 resulted primarily from an increase in net investment income of $160 million and increased private giving of $111 million. Net assets also increased due to a continued focus on cost containment throughout the University. Operating revenues and state educational appropriations increased 5 percent, or $195 million, while total expenses only increased 4 percent, or $146 million.

The University invests its financial assets to maximize total return, with an appropriate level of risk. While the University's working capital is invested in relatively short duration assets, the University invests its endowment with a strategy that seeks to maximize total return over the long term. The success of this long-term investment strategy is evidenced by strong returns over sustained periods of time and the University's ability to limit losses in the face of challenging markets.

Using the Financial Statements

The University's financial report includes three financial statements: the Statement of Net Assets; the Statement of Revenues, Expenses and Changes in Net Assets; and the Statement of Cash Flows. These financial statements are prepared in accordance with Governmental Accounting Standards Board ("GASB") principles, which establish standards for external financial reporting for public colleges and universities and require that financial statements be presented on a consolidated basis to focus on the University as a whole.

Statement of Net Assets

The statement of net assets presents the financial position of the University at the end of the fiscal year and includes all assets and liabilities of the University. The difference between total assets and total liabilities—net assets—is one indicator of the current financial condition of the University, while the change in net assets is an indicator of whether the overall financial condition has improved or worsened during the year. Assets and liabilities are generally measured using current values. One notable exception is capital assets, which are stated at historical cost less an allowance for depreciation. A comparison of the University's assets, liabilities and net assets at June 30, 2005 and 2004 is summarized as follows:

	2005	2004
	(in millions)	
Current assets	$ 2,248	$ 2,158
Noncurrent assets:		
Endowment, life income and other investments	5,196	4,349
Capital assets, net	3,105	2,839
Other	235	150
Total assets	10,784	9,496
Current liabilities	754	741
Noncurrent liabilities	1,220	1,025
Total liabilities	1,974	1,766
Net assets	$ 8,810	$ 7,730

A review of the statement of net assets at June 30, 2005 and 2004 shows that the University continues to maintain and protect its strong financial foundation. This financial health reflects the prudent utilization of financial resources, including careful cost controls, preservation of endowment funds, conservative utilization of debt and adherence to a long range capital plan for the maintenance and replacement of the physical plant.

Current assets consist primarily of cash and cash equivalents, operating and capital investments, and accounts receivable. Total current assets increased $90 million, to $2.2 billion at June 30, 2005. Cash and cash equivalents and operating investments totaled $1.1 billion at June 30, 2005, which represents approximately three months of total expenses, excluding depreciation.

Current liabilities consist primarily of accrued compensation and accounts payable, which totaled $464 million at June 30, 2005 and $403 million at June 30, 2004. Current liabilities also include deferred revenue, commercial paper and the current portion of bonds payable and insurance and benefits reserves. Total current liabilities increased $13 million, to $754 million at June 30, 2005. This increase is due primarily to a $32 million increase in accrued compensation and a $29 million increase in accounts payable, offset by a $45 million decrease in commercial paper.

Endowment, Life Income and Other Investments

The University's endowment, life income and other investments increased $848 million, to $5.2 billion at June 30, 2005. This increase primarily resulted from favorable investment performance and the receipt of new endowment funds through gifts and transfers, offset by endowment distributions to beneficiary units for operations. The composition o f the University's endowment, life income and other investments at June 30, 2005 and 2004 is summarized as follows:

	2005	2004
	(in millions)	
Endowment investments	$ 4,931	$ 4,163
Noncurrent portion of insurance and benefits reserves and managed care investments	178	105
Life income investments	87	81
	$ 5,196	$ 4,349

The University's endowment funds consist of both permanent endowments and funds functioning as endowments. Permanent endowments are those funds received from donors with the stipulation that the principal remain inviolate and be invested in perpetuity to produce income that is to be expended for the purposes specified by the donors. Funds functioning as endowment consist of amounts (restricted gifts or unrestricted funds) that have been allocated by the University for long-term investment purposes, but are not limited by donor stipulations requiring the University to preserve principal in perpetuity. Programs supported by endowment funds include scholarships, fellowships, professorships, research efforts, and other important programs and activities.

The University uses its endowment funds to support operations in a way that strikes a balance between generating a predictable stream of annual support for current needs and preserving the purchasing power of the endowment funds for future periods. The major portion of the endowment is maintained in the University Endowment Fund, which is invested in the University's Long Term Portfolio, a single diversified investment pool. The University's

endowment spending rate policy provides for an annual distribution of 5 percent of the one-quarter lagged, three-year moving average fair market value of University Endowment Fund assets, with distributions limited to 5.3 percent of current market value. Any capital gains or income generated above the spending rate are reinvested so that in lean times funds will be available. Because the spending rate is based on a three-year moving average fair market value, the percent distributed for operating purposes is different when stated in the context of current fair market value. Actual distributions were 4.2 percent, 4.7 percent and 5.3 percent of the market value of the endowment at June 30, 2005, 2004 and 2003, respectively.

Capital and Debt Activities

One of the critical factors in continuing the quality of the University's academic, research and clinical programs is the development and renewal of capital assets. The University continues to implement its long-range plan to modernize its complement of older teaching, research and clinical facilities, along with balanced investment in new construction.

Capital asset additions totaled $524 million in 2005, as compared to $463 million in 2004. Capital asset additions primarily represent replacement, renovation and new construction of academic, research and clinical facilities, as well as significant investments in equipment, including information technology. Current year capital asset additions were primarily funded with gifts and net assets designated for capital purposes of $448 million, as well as debt proceeds of $69 million and state capital appropriations of $7 million.

Construction in process, which totaled $648 million at June 30, 2005 as compared to $386 million at June 30, 2004, includes important new facilities for life sciences and medical research, instruction and patient care.

The Biomedical Science Research Building, whose construction commenced in 2002, will serve as an entry to the Medical Campus from the Central Campus and is located across from the Palmer Drive Life Sciences Development. This new state-of-the-art facility is designed to foster multidisciplinary collaborations and interaction between students, faculty and scientists to profoundly impact science and clinical care. The University expects this facility to be completed by December 2005. Construction also continues on the Undergraduate Science Building, which will house teaching laboratories and instructional space for undergraduate students, as part of the Palmer Drive Life Sciences Development.

The Cardiovascular Center, which began construction in 2004, will be one of the nation's first fully comprehensive cardiovascular treatment centers, with operating rooms, patient rooms, clinics, classrooms and laboratories. In addition to giving cardiovascular patients an all-in-one location for their care, this new clinical building will help meet the surging demand for cardiovascular services and bring together specialized services and facilities that are now located throughout the University's health system. The University expects this facility to be completed in 2007. To provide parking for patients and staff, a 465-space parking structure will also be constructed as part of this project.

The Computer Science and Engineering Building, whose construction commenced in 2004, will be a state-of-the-art academic facility to provide learning spaces for students and support computer science and information technology. Located on North Campus, this new facility will also house the College of Engineering's computer science and engineering faculty, as well as accompanying technical and support staff. Also located on North Campus, the Advanced Technology Laboratories building is undergoing a renovation and expansion to accommodate growth in cellular and molecular biotechnology engineering activities and to provide space for new undergraduate degree programs in biomedical engineering. The University expects these facilities to be completed in 2006.

Significant renovation projects in process at June 30, 2005 include the School of Public Health and Literature, Science and Arts ("LSA") buildings. The School of Public Health renovation project will provide modernization of building systems and additional space, through replacement of the east-west wing of the Henry F. Vaughan Public Health Building with modern laboratories, classrooms, conference rooms and community focused research space. The addition will also connect to the Thomas Francis Jr. Building to form one public health complex. Overall, the project aims to better equip public health for newly emerging priorities such as bioterrorism preparedness, understanding new genetic technologies and the globalization of health, as well as to provide needed laboratory space. The LSA Building, which was constructed in 1948, is in need of significant infrastructure improvements. The LSA Building renovation project will provide a complete upgrade of mechanical, plumbing, electrical and life safety systems, and improve accessibility throughout the building. The University expects these projects to be completed in 2006.

The University takes seriously its financial stewardship responsibility and works hard to manage its financial resources effectively, including the prudent use of debt to finance capital projects. A strong debt rating is an important indicator of the University's success in this area. In January 2005, Standard & Poor's Ratings Services upgraded the University to its highest rating (AAA) for bonds backed by a broad revenue pledge. This upgrade reflects the University's national reputation for excellence, strong financial performance and manageable debt burden and capital plan. Moody's Investors Service also reaffirmed its highest credit rating (Aaa) based on the University's strong credit fundamentals, including superior financial resources, strong market position and excellent operating results derived from a well diversified revenue base. Only two other public university systems have received the highest credit ratings from both Moody's and Standard & Poor's.

Long-term debt activity for the year ended June 30, 2005, and the type of revenue it is supported by, is summarized as follows:

	Beginning Balance	Additions	Reductions	Ending Balance
	(in millions)			
Commercial Paper:				
General revenues	$ 76	$ 121	$ 166	$ 31
Bonds and Notes:				
General revenues	194	90	9	275
Hospital revenues	308	150	7	451
Faculty Group Practice revenues	100		2	98
Student residences revenues	16		1	15
Student fee revenues	37		32	5
	$ 731	$ 361	$ 217	$ 875

The University maintains a combination of fixed and variable rate debt, with effective interest rates that averaged 3.22 percent in 2005, 2.74 percent in 2004 and 2.82 percent in 2003. Consistent with the University's capital and debt financing plans, total outstanding debt increased $144 million, or 20 percent, to $875 million at June 30, 2005, while interest expense increased 12 percent, to $22 million.

The University utilizes commercial paper, backed by a general revenue pledge, to provide interim financing for its capital improvement program. Outstanding commercial paper is converted to long-term debt financing, as appropriate, within the normal course of business. At June 30, 2005 and 2004, commercial paper totaled $31 million and $76 million, respectively, and is included in current liabilities.

In March 2005, the University issued $86 million in fixed and variable rate general revenue bonds, with a net original issue premium of $4 million. Proceeds from this bond issue were used to convert $30 million of commercial paper to long-term debt, refund $29 million of student fee bonds and provide $20 million of funds for renovations of the L S A Building and new construction of various capital projects on the Ann Arbor and Dearborn campuses. Proceeds from this bond issue will also be used to refund $11 million of housing revenue bonds in November 2006. As a result of the debt refunding portion of this bond issue, the University will reduce its aggregate debt service payments over the next 13 years by approximately $5 million to obtain an economic gain (present value savings) of $4 million. Of the total bond issue, $38 million (Series 2005A) is fixed rate debt and $48 million (Series 2005B) is variable rate debt.

In June 2005, the University issued $150 million in variable rate hospital revenue bonds to provide $94 million of funds for new construction of the Cardiovascular Center and improvements to the electrical substation and underground distribution system, as well as convert $56 million of commercial paper to long-term debt. Of the total bond issue, $69 million (Series 2005A) is variable rate debt and $81 million (Series 2005B) is variable rate debt with a corresponding swap to fixed rate.

Net Assets

Net assets represent the residual interest in the University's assets after liabilities are deducted. The composition of the University's net assets at June 30, 2005 and 2004 is summarized as follows:

	2005	2004
	(in millions)	
Invested in capital assets, net of related debt	$ 2,342	$ 2,122
Restricted:		
Nonexpendable:		
Permanent endowment corpus	818	749
Expendable:		
Net appreciation of permanent endowments	804	612
Funds functioning as endowment	1,062	944
Restricted for operations and other	504	391
Unrestricted	3,280	2,912
	$ 8,810	$ 7,730

Net assets invested in capital assets represent the University's capital assets net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets. The $220 million net increase reflects the University's continued development and renewal of its capital assets in accordance with its long-range capital plan.

Restricted nonexpendable net assets represent the historical value (corpus) of gifts to the University's permanent endowment funds. The $69 million increase primarily represents new gifts. Restricted expendable net assets are subject to externally imposed stipulations governing their use. This category of net assets includes net appreciation of permanent endowments, funds functioning as endowment and net assets restricted for operations, facilities and student loan programs. Restricted expendable net assets totaled $2.4 billion at June 30, 2005, as compared to $1.9 billion at June 30, 2004.

Although unrestricted net assets are not subject to externally imposed stipulations, all of the University's unrestricted net assets have been designated for various academic and research programs and initiatives, as well as capital projects. In addition, unrestricted net assets include funds functioning as endowment of $2.1 billion and $1.8 billion at June 30, 2005 and 2004, respectively.

Statement of Revenues, Expenses and Changes in Net Assets

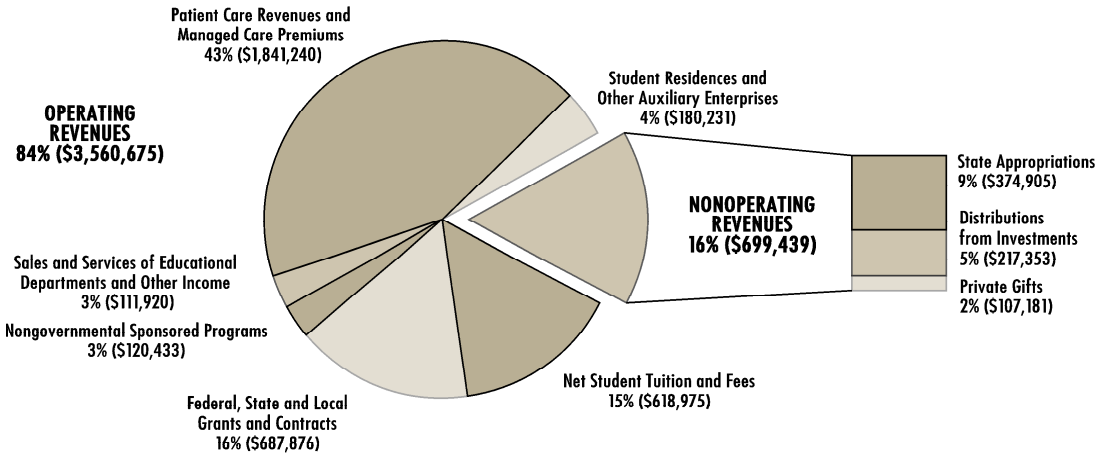
The statement of revenues, expenses and changes in net assets presents the University's results of operations. In accordance with GASB reporting principles, revenues and expenses are classified as either operating or nonoperating. A comparison of the University's revenues, expenses and changes in net assets for the three years ended June 30, 2005 is summarized as follows:

	2005	2004	2003
		(in millions)	
Operating revenues:			
Student tuition and fees, net of scholarship allowances	$ 619.0	$ 599.4	$ 557.9
Sponsored programs	808.3	792.7	762.9
Patient care revenues and managed care premiums	1,841.2	1,712.3	1,569.3
Other	292.2	279.4	261.0
	3,560.7	3,383.8	3,151.1
Operating expenses	4,026.1	3,882.7	3,705.5
Operating loss	(465.4)	(498.9)	(554.4)
Nonoperating and other revenues (expenses):			
State educational appropriations	374.9	356.9	401.1
Private gifts	107.2	71.8	62.3
Net investment income	874.6	714.6	234.4
Interest expense	(21.7)	(19.4)	(22.3)
State capital appropriations	7.0	31.9	33.7
Endowment and capital gifts and grants	197.2	121.6	105.3
Other, net	6.6	(8.8)	(9.1)
Nonoperating and other revenues, net	1,545.8	1,268.6	805.4
Increase in net assets	1,080.4	769.7	251.0
Net assets, beginning of year	7,729.9	6,960.2	6,709.2
Net assets, end of year	$ 8,810.3	$ 7,729.9	$ 6,960.2

One of the University's greatest strengths is the diverse streams of revenue that supplement its student tuition and fees, including voluntary private support from individuals, foundations and corporations, along with government a n d other sponsored programs, state appropriations and investment income. As in the past, the University continues to aggressively seek funding from all possible sources consistent with its mission to supplement student tuition and to prudently manage the financial resources realized from these efforts to fund its operating activities.

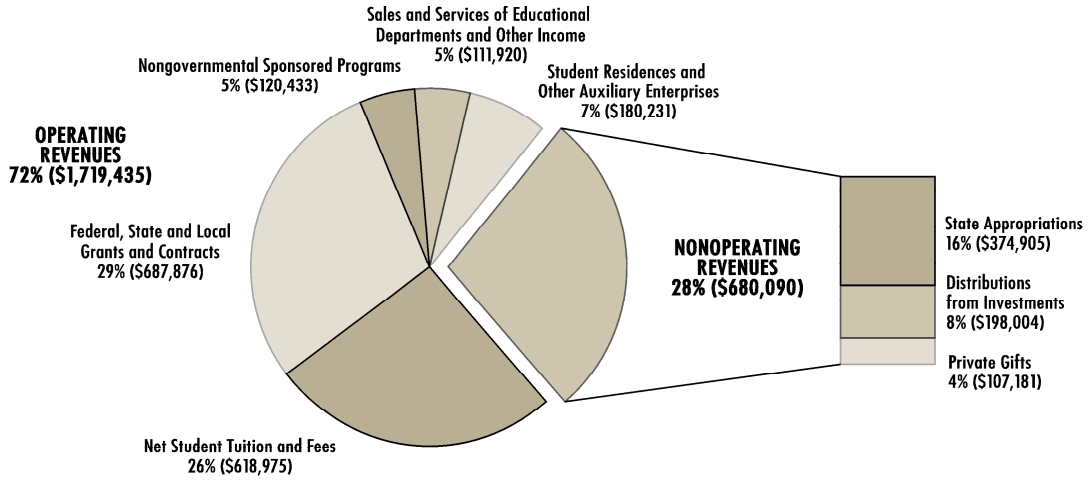
The following is a graphic illustration of revenues by source (both operating and nonoperating), which are used to fund the University's operating activities for the year ended June 30, 2005 (amounts are presented in thousands of dollars). Significant recurring sources of the University's revenues are considered nonoperating, as defined by GASB, such as state appropriations, private gifts and distributions from investments.

FISCAL YEAR 2005 REVENUES FOR OPERATING ACTIVITIES



The University measures its performance both for the University as a whole and for the University without its hospitals, health centers and similar activities. The exclusion of the University's Health System allows a clearer view of the operations of the schools and colleges, as well as the central administration. The following is a graphic illustration of University revenues by source (both operating and nonoperating), which are used to fund operating activities other than the hospitals, health centers and similar activities, for the year ended June 30, 2005 (amounts are presented in thousands of dollars).

FISCAL YEAR 2005 REVENUES FOR OPERATING ACTIVITIES EXCLUDING REVENUES FROM THE UNIVERSITY'S HEALTH SYSTEM



Tuition and state appropriations are the primary sources of funding for the University's academic programs. There is a direct relationship between the growth or reduction in state support and the University's ability to restrain tuition fee increases. Together, net student tuition and fees and state appropriations only increased 4 percent, or $38 million, to $994 million in 2005 and decreased 0.3 percent, or $3 million, to $956 million in 2004. During the last four years of declining state appropriations, the University's tuition increases have been among the lowest in the state and in the Big Ten, which reflects a commitment to affordable higher education for Michigan families. At the same time, the University has also increased scholarship allowances to benefit students in financial need.

Net revenues from state educational appropriations decreased $26 million, or 7 percent, over the past three years to $375 million in 2005. For the three years ended June 30, 2005, state educational appropriations revenue consisted of the following components:

	2005	2004	2003
		(in millions)	
Base appropriations	$ 366.6	$ 374.1	$ 415.6
Net restoration (rescission)	8.3	(17.2)	(14.5)
	$ 374.9	$ 356.9	$ 401.1

Downturns in state tax revenues continue to put pressure on the state budget. Consequently, base appropriations have declined 12 percent, or $49 million, over the past two years to $367 million in 2005. Due to volatility in the state budget, the University's base appropriations have also been subject to mid-year rescission and restoration over the last three years. The net restoration in 2005 primarily represents the return of a portion of the 2004 mid-year rescission because the University limited its 2005 resident undergraduate tuition increases to inflation. This also enabled the University to experience a more moderate cut, of 2 percent, in base appropriations in 2005.

To offset the decrease in state appropriations, net student tuition and fees revenue has increased 11 percent, or $61 million, over the past three years to $619 million in 2005. For the three years ended June 30, 2005, net student tuition and fees consisted of the following components:

	2005	2004	2003
		(in millions)	
Student tuition and fees	$ 765.2	$ 731.2	$ 687.4
Scholarship allowances	(146.2)	(131.8)	(129.5)
	$ 619.0	$ 599.4	$ 557.9

In 2005, net student tuition and fees revenue increased 3 percent, or $20 million, to $619 million, which reflects a 5 percent, or $34 million, increase in gross tuition and fee revenues offset by an 11 percent, or $14 million, increase in scholarship allowances. Tuition rate increases in 2005 were 2.8 percent for resident undergraduate students, with a 5 percent increase in most other tuition rates including those for nonresidents, with a modest growth in the number of students.

In 2004, net student tuition and fees revenue increased 7 percent, or $42 million, to $599.4 million, which reflects a 6 percent, or $44 million, increase in gross tuition and fee revenues offset by a 2 percent, or $2 million, increase in scholarship allowances. Tuition rate increases in 2004 averaged 6.5 percent for undergraduate programs and 6.0 percent for graduate level programs, with a modest growth in the number of students.

While tuition and state appropriations fund a large percentage of University costs, private support is becoming increasingly essential to the University's academic distinction. Private gift revenues for operations totaled $107 million in 2005, as compared to $72 million in 2004, and $62 million in 2003.

The University receives revenues for sponsored programs from various government agencies and private sources, which normally provide for both direct and indirect costs to perform these sponsored activities. Revenues for sponsored programs increased 2 percent, or $16 million, to $808 million in 2005. For 2004, revenues for sponsored programs increased 4 percent, or $30 million, to $793 million. A significant portion of the University's sponsored programs revenues relate to federal research and its growth is consistent with the national trend of stabilized federal research activity.

Patient care revenues and managed care premiums increased 7.5 percent, or $129 million, to $1.8 billion in 2005, as compared to an increase of 9 percent, or $143 million, to $1.7 billion in 2004. The majority of these revenues relate to patient care services, which are principally generated within the University's hospitals and ambulatory care facilities under contractual arrangements with governmental payers and private insurers. Increased revenues primarily resulted from a growth in both outpatient and inpatient volume, as well as increased reimbursement rates from third party payers.

Net investment return for the three years ended June 30, 2005 is summarized as follows:

	2005	2004	2003
		(in millions)	
Interest and dividends, net	$ 195.9	$ 142.4	$ 128.1
Increase in fair value of investments	678.7	572.2	106.3
Net investment income	$ 874.6	$ 714.6	$ 234.4

Net investment income totaled $875 million in 2005, as compared to $715 million in 2004 and $234 million in 2003. The improvement in net investment income is primarily due to improved market conditions resulting in increased realized and unrealized gains for both equity and alternative type investments. As discussed previously, the University's endowment investment policies are designed to maximize long-term total return, while its income distribution policy is designed to preserve the value of the endowment and generate a predictable stream of spendable income.

With The Michigan Difference capital campaign well underway, endowment and capital gifts and grants increased $76 million, to $197 million, in 2005. Of this increase, capital gifts and grants increased $69 million, to $119 million and endowment gifts increased $7 million, to $78 million. For 2004, endowment and capital gifts and grants increased $16 million, to $122 million. Of this increase, capital gifts and grants increased $10 million, to $50 million and endowment gifts increased $6 million, to $72 million. The continued growth in capital gifts and grants primarily relates to gifts received in support of Ross School of Business, Health System, Intercollegiate Athletics and College of Engineering capital projects.

In addition to revenue diversification, the University continues to make cost containment an ongoing priority. This is necessary as the University continues to face significant financial pressure, particularly in the areas of compensation and benefits, which represent 64 percent of total expenses, as well as in the areas of technology and ongoing maintenance of facilities and infrastructure.

A comparative summary of the University's expenses for the three years ended June 30, 2005 is as follows (amounts in millions):

	2005		2004		2003	
Operating:						
Compensation and benefits	$ 2,592.1	64%	$ 2,484.7	64%	$ 2,356.4	63%
Supplies and services	1,104.9	27	1,070.9	27	1,041.7	28
Depreciation	253.7	6	245.8	6	229.0	6
Scholarships and fellowships	75.4	2	81.3	2	78.4	2
	4,026.1	99	3,882.7	99	3,705.5	99
Nonoperating:						
Interest	21.7	1	19.4	1	22.3	1
	$ 4,047.8	100%	$ 3,902.1	100%	$ 3,727.8	100%

The University is committed to recruiting and retaining outstanding faculty and staff and the compensation package is one way to successfully compete with peer institutions and nonacademic employers. The resources expended for compensation and benefits increased 4 percent, or $107 million, to $2.6 billion in 2005. Of this increase, compensation increased 5 percent, to $2.02 billion, and employee benefits increased 1 percent, to $570 million. For 2004, compensation increased 5 percent, to $1.92 billion, and employee benefits increased 8 percent, to $566 million.

The majority of the compensation increase occurred in the Health System, where nursing and other health professionals were added to support higher patient volume levels. Increases in wage rates also accounted for a significant portion of the expense growth, reflecting a high demand for nurses and other health professionals, and an industry-wide shortage of personnel in these fields. In addition, staffing levels were increased in many administrative and support areas, to further strengthen these areas and in response to an increasing regulatory burden borne by hospitals. In 2005, the Health System had a growth in compensation of 8 percent and a growth in employees of 4 percent, while the rest of the University had a growth in compensation of 3 percent and a decrease in employees of 1 percent.

Employee benefits grew at a slower rate than compensation in 2005, primarily as a result of favorable experience in self-insured benefit programs as well as proactive management of health benefit programs. Health benefits are one of the most significant employee benefits and the University has implemented several initiatives to better control its rate of increase over the past several years.

Following the implementation a 5 percent co-premium in January 2004 for most employees and retirees, the University moved to a more comprehensive premium sharing model. Prior to this, approximately 70 percent of employees and retirees did not contribute toward their health insurance premiums.

Commencing in January 2005, the University began to pay 95 percent of the average health insurance single coverage premiums of the two lowest-cost comprehensive plans, and 85 percent of the total aggregate premium for employees, retirees and covered dependents. At this time, the University also moved from a three-tier to a four-tier structure of coverage to reflect the lower health care costs of children. In addition, the University offered two new preferred provider organization (PPO) health plans to provide lower cost health coverage options to participants residing outside the health maintenance organization (HMO) service areas. These changes are designed to encourage employees to choose the lowest cost insurance plan that meets their needs and to share with employees a small portion of future health insurance cost increases.

The University also engaged a single pharmacy benefit manager to manage all pharmacy benefits with University oversight, commencing in January 2003. Utilizing this prescription drug "carve-out" structure has reduced administrative costs and increased discounts and rebates from pharmaceutical manufacturers.

These initiatives reflect the reality of the national landscape, while remaining true to the commitment we make to our employees for a robust benefits package, which is essential for recruiting and retaining faculty and staff.

Supplies and services expenses increased 3 percent, or $34 million, to $1.1 billion in 2005, as compared to a 3 percent, or $29 million, increase in 2004. The University continued cost containment efforts, including sustained focus on reducing the cost of supplies and their related transaction costs.

In addition to their natural (object) classification, it is also informative to review operating expenses by function. A comparative summary of the University's expenses by functional classification for the three years ended June 30, 2005 is as follows (amounts in millions):

	2005		2004		2003	
Operating:						
Instruction	$ 669.6	17%	$ 655.9	17%	$ 643.2	17%
Research	522.8	13	506.4	13	509.3	14
Public service	102.5	2	97.6	2	85.0	2
Institutional and academic support	352.3	9	330.6	9	330.0	9
Auxiliary enterprises:						
Patient and managed care	1,719.3	42	1,605.7	41	1,475.4	40
Other	117.7	3	146.2	4	161.8	4
Operations and maintenance of plant	212.7	5	213.2	5	193.4	5
Depreciation	253.8	6	245.8	6	229.0	6
Scholarships and fellowships	75.4	2	81.3	2	78.4	2
	4,026.1	99	3,882.7	99	3,705.5	99
Nonoperating:						
Interest	21.7	1	19.4	1	22.3	1
	$ 4,047.8	100%	$ 3,902.1	100%	$ 3,727.8	100%

Instruction, research and public service expenses increased 3 percent, or $35 million, to $1.3 billion in 2005, as compared to a 2 percent, or $22 million, increase in 2004. These increases are consistent with the level of growth in the related revenue sources.

To measure its total volume of research expenditures, the University considers research expenses, included in the above table, as well as research related facilities and administrative expenses, research initiative and start-up expenses, and research equipment purchases. These amounts aggregated $778 million in 2005, as compared to $753 million in 2004 and $749 million in 2003. This represents an increase of 4 percent, or $29 million, from 2003 to 2005. The growth in this area is consistent with the growth in federal sponsored programs revenues.

Patient and managed care expenses increased 7 percent, or $114 million, to $1.7 billion in 2005, as compared to a 9 percent, or $130 million increase in 2004. The growth in this area is consistent with the growth in related revenues.

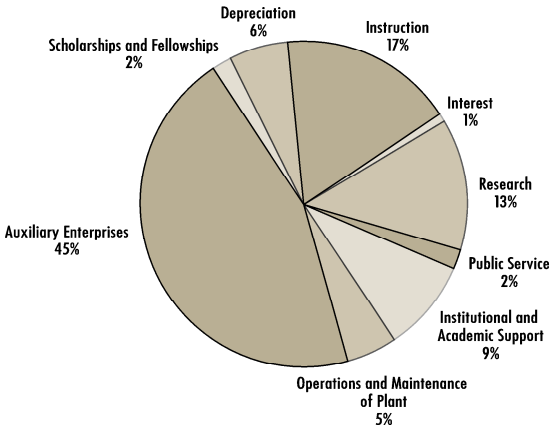
Management's Discussion and Analysis (UNAUDITED)

Total scholarships and fellowships provided to students aggregated $236 million in 2005, as compared to $227 million in 2004 and $221 million in 2003, an increase of 7 percent. Tuition, housing and fees revenues are reported net of aid applied to students' accounts, while amounts paid directly to students are reported as scholarship and fellowship expense. Scholarships and fellowships for the three years ended June 30, 2005 are summarized as follows:

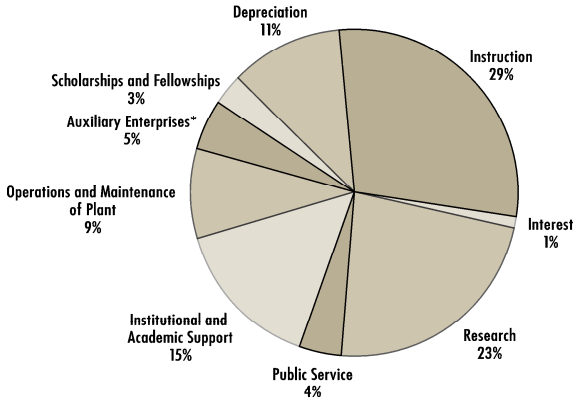
	2005	2004	2003
		(in millions)	
Paid directly to students	$ 75.4	$ 81.3	$ 78.4
Applied to tuition and fees	146.2	131.8	129.5
Applied to University Housing	14.8	14.1	13.4
	$ 236.4	$ 227.2	$ 221.3

The following graphic illustrations present total expenses by function, with and without the University's hospitals, health centers and similar activities:

FISCAL YEAR 2005 EXPENSES BY FUNCTION



FISCAL YEAR 2005 EXPENSES BY FUNCTION EXCLUDING EXPENSES FROM THE UNIVERSITY'S HEALTH SYSTEM



**Excludes expenses from the University's Health System of $1.7 billion*

Statement of Cash Flows

The statement of cash flows provides additional information about the University's financial results, by reporting the major sources and uses of cash. A comparative summary of the statement of cash flows for the years ended June 30, 2005 and 2004 is as follows:

	2005	2004
	(in millions)	
Cash received from operations	$ 3,593.1	$ 3,410.0
Cash expended for operations	(3,783.8)	(3,643.0)
Net cash used in operating activities	(190.7)	(233.0)
Net cash (used in) provided by investing activities	(24.9)	41.4
Net cash used in capital and related financing activities	(322.2)	(397.2)
Net cash provided by noncapital financing activities	546.6	508.3
Net increase (decrease) in cash and cash equivalents	8.8	(80.5)
Cash and cash equivalents, beginning of year	360.4	440.9
Cash and cash equivalents, end of year	$ 369.2	$ 360.4

Cash received from operations primarily consists of student tuition, sponsored programs grants and contracts, and patient care revenues. Significant sources of cash provided by noncapital financing activities, as defined by GASB, include state appropriations and private gifts used to fund operating activities. Cash and cash equivalents increased $8.8 million in 2005, as compared to a decrease of $80 million in 2004.

Economic Factors That Will Affect the Future

Over the last three years, the University has successfully faced significant financial challenges to its academic programs, stemming from unprecedented cuts in state appropriations. Given the continuation of this difficult state environment, it is especially impressive that Standard & Poor's upgraded the University to its highest credit rating (AAA). Receiving this upgrade and continuing to maintain Moody's Investors Services highest credit rating (Aaa) reflects the University's strong fiscal stewardship and its level of excellence in service to students, patients, the research community, the state and the nation. Achieving and maintaining the highest credit ratings obtainable provides the University a high degree of flexibility in securing capital funds on the most competitive terms. This flexibility, along with ongoing efforts toward revenue diversification and cost containment, will enable the University to provide the necessary resources to support this level of excellence.

A crucial element to the University's future continues to be our strong relationship with the State of Michigan, as we work to manage tuition to make it competitive while providing an outstanding college education for our students. Historically, there has been a direct relationship between the growth or reduction of state support and the University's ability to control tuition increases, as reduced growth in state appropriations generally necessitates increased tuition levels.

While the University acknowledges the seriousness of the State's budget situation and has taken meaningful steps to reduce expenses throughout the University's operations, higher education is critical to the success of the state's economic future and, over the long term, a more sustainable model of state support must be considered. The accumulated effects of reduced state appropriations are considerable and over time it becomes difficult to sustain the resultant cost reductions while maintaining the high caliber of our academic programs. To preserve the quality of a Michigan education, the University's budget for 2006 includes a 12.3 percent tuition increase for resident undergraduates and a 6 percent increase for nonresident undergraduates on the Ann Arbor campus, along with an 11.9 percent tuition increase for the Dearborn and Flint campuses. The decision to recommend significant tuition increases was not an easy one, particularly in light of concerns that the University remain affordable; however, the University has also increased centrally budgeted financial aid by 28 percent.

Private gifts are an increasingly important supplement to the fundamental support provided by state appropriations and student tuition to maintain academic quality and support future initiatives. The University launched the public phase of a major fundraising campaign in May 2004, with the announcement of an ambitious goal of $2.5 billion. The campaign, titled "The Michigan Difference," will provide support for student scholarships and fellowships, endowed professorships, facilities, academic programs, research and other projects. Since launching the quiet phase of the campaign in 2000, the University has raised $1.5 billion in cash and pledges and $282 million in bequests, a total of $1.8 billion, or 72 percent of the goal. The campaign will continue through December 2008.

The University continues to execute its long-range plan to modernize and expand its complement of older teaching and research facilities, while adding key new facilities for life sciences and medical research. This strategy addresses the University's growth and the continuing effects of technology on teaching and research methodologies. Authorized costs to complete construction and other projects totaled $692 million at June 30, 2005. Funding for these projects is anticipated to include $554 million from gifts and net assets designated for capital purposes, $111 million from the utilization of unexpended debt proceeds and $27 million from the State Building Authority. While the State of Michigan's Building Authority continues to support the University's systematic renewal of core academic facilities, economic pressures affecting the State may also affect the State's future support.

The University will continue to employ its long-term investment strategy to maximize total returns, at an appropriate level of risk, while utilizing a spending rate policy to preserve endowment capital and insulate the University's operations from temporary market volatility.

While the University's Hospitals and Health Centers are also well positioned to maintain a strong financial position in the near term, ongoing constraints on revenue are expected due to fiscal pressures from employers and federal and state governments. Management believes that much of the payment pressure can be offset by growth in patient volume and continued efforts to contain certain costs.

As a labor-intensive organization, the University faces competitive pressures related to attracting and retaining faculty and staff. Moreover, the cost of the University's health benefits has increased dramatically over the past several years, with the increasing cost of medical care and prescription drugs of particular concern. The University also faces the challenge of funding its post-employment benefit plans, which include retiree health insurance.

To address these challenges, the University has successfully taken and continues to take proactive steps to slow the rate of increase in health benefits expenses. For example, in January 2006, the University will change vendors for pharmacy benefit claim processing and mail order services; the new arrangement is expected to save $1 million annually due to better discounts for retail and mail order pricing arrangements and additional rebates. In addition,

the prescription drug "carve-out" structure that the University implemented in 2003 has the added benefit of enabling the University to receive a Medicare Part D subsidy of approximately $3 million annually, commencing in 2006. This recently enacted section of the Medicare Act provides for a non-taxable federal subsidy to sponsors of retiree health care benefit plans that provide outpatient prescription drug that is at least "actuarially equivalent" to the benefit established by the Act.

The Medicare subsidy, along with other recent health benefit initiatives such as plan changes designed to encourage employees to choose the lowest cost insurance plan that meets their needs and to share with employees a small portion of future health insurance cost increases, also have a favorable impact on the University's retiree health insurance benefit plans.

Certain organizations are currently required to record the estimated present value of post-retirement benefits as a liability in their financial statements. Although the University is not presently required to record this liability, GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* issued in June 2004, calls for the measurement and recognition of the cost of other postemployment benefits ("OPEB") during the periods when employees render their services. The University is required to implement this Statement in fiscal 2008, which will result in an increase in liabilities and a decrease in net assets to reflect the actuarially determined liability for OPEB. Using current actuarial assumptions, and presuming a continuation of the current level of benefits, the value of those benefits is estimated to total $1.2 billion at June 30, 2005. Implementing the health benefits initiatives described above has resulted in a $300 million favorable impact to this estimate.

While it is not possible to predict the ultimate results, management believes that the University's financial condition will remain strong.