Approved by the Regents
October 20, 2016

THE UNIVERSITY OF MICHIGAN
REGENTS COMMUNICATION

ACTION REQUEST

SUBJECT: The University of Michigan Financial Statements for the Year Ended June 30, 2016

ACTION REQUESTED: Adoption of Financial Statements

The Board of Regents has received the University's consolidated audited financial statements for fiscal year 2016, as well as separate audited financial statements for the Hospitals and Health Centers, Intercollegiate Athletics, and the Veritas Insurance Corporation. The Board has had a discussion with PricewaterhouseCoopers LLP, the University's independent auditors. We recommend adoption of the University's consolidated audited financial statements as submitted.

Respectfully submitted,

Kevin P. Hegarty
Executive Vice President and
Chief Financial Officer

October 2016
Attachment

UNIVERSITY OF MICHIGAN

CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2016 and 2015
with
REPORT OF INDEPENDENT AUDITORS

UNIVERSITY OF MICHIGAN

June 30, 2016 and 2015

Report of Independent Auditors

To The Regents of the University of Michigan:

We have audited the accompanying consolidated financial statements of the University of Michigan (the "University") as of and for the years ended June 30, 2016 and 2015, and the related notes to the consolidated financial statements, which consist of the consolidated statements of net position and the related consolidated statements of revenues, expenses and changes in net position and of cash flows.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the University's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

PricewaterhouseCoopers LLP, 500 Woodward Avenue, Detroit, MI 48226
T: (313) 394 6000, F: (313) 394 6555 www.pwc.com/us

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the University at June 30, 2016 and 2015, and the changes in its financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matter

The accompanying management's discussion and analysis on pages 3 through 27 is required by accounting principles generally accepted in the United States of America to supplement the basic consolidated financial statements. Such information, although not a part of the basic consolidated financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic consolidated financial statements, and other knowledge we obtained during our audits of the basic consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

PricewaterhouseCoopers LLP

October 20, 2016

PricewaterhouseCoopers LLP, 500 Woodward Avenue, Detroit, MI 48226
T: (313) 394 6000, F: (313) 394 6555 www.pwc.com/us

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, 2016 and 2015 and its activities for the three fiscal years ended June 30, 2016. 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 over 61,000 students and approximately 7,900 faculty members on three campuses in southeast Michigan. The University offers a diverse range of degree programs from baccalaureate to post-doctoral levels through 19 schools and colleges, and contributes to the state and nation through related research and public service programs. The University also has a nationally renowned health system which includes three hospitals, 40 health centers, more than 150 outpatient clinics, the University's Medical School and Michigan Health Corporation, a wholly-owned corporation created to pursue joint venture and managed care initiatives. The University employs over 46,000 regular employees and approximately 13,000 temporary staff.

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. Research is central to the University's mission and a key aspect of its strong reputation among educational institutions. The University is widely recognized for the breadth and excellence of its research enterprise as well as for the exceptional level of cooperation across disciplines, which allows faculty and students to address the full complexity of real-world challenges. 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 $18.5 billion and liabilities of $5.5 billion at June 30, 2016, compared to assets of $18.5 billion and liabilities of $5.2 billion at June 30, 2015. Net position, which represents the residual interest in the University's assets after liabilities are deducted, totaled $13.0 billion and $13.3 billion at June 30, 2016 and 2015, respectively. Changes in net position represent the University's results of operations and are summarized for the years ended June 30, 2016 and 2015 as follows:

	2016	2015
	(in millions)	
Operating revenues and educational appropriations	$ 6,667.1	$ 6,307.6
Private gifts for operating activities	167.2	172.0
Operating and net interest expenses	(7,200.8)	(6,735.1)
	(366.5)	(255.5)
Net investment (loss) income	(129.7)	357.8
Endowment, capital gifts and grants and other	201.6	135.4
(Decrease) increase in net position	$ (294.6)	$ 237.7

Net position decreased $295 million in 2016 after an increase of $238 million in 2015 primarily as a result of a net investment loss of $130 million in 2016, as compared to net investment income of $358 million in 2015.

In 2016, operating revenues and educational appropriations increased 5.7 percent, or $360 million, while total operating and net interest expenses increased 6.9 percent, or $466 million. Endowment, capital gifts and grants and other revenues increased $66 million in 2016 as a result of state capital appropriations and underlying activity associated with the Victors for Michigan campaign which was launched in November 2013.

The results of operations reflect the University's focus on maintaining its national standards academically, in research and in health care within a competitive recruitment environment for faculty and health care professionals and a period of reduced federal funding for research. At the same time, the University is addressing constrained state appropriations and rising health care, regulatory and facility costs with aggressive cost cutting and productivity gains to help preserve access to affordable higher education for Michigan families. To achieve aggressive and sustainable long-term goals for cost cutting and productivity gains, the University is also strategically utilizing resources to bridge cuts and support enterprise-wide information technology projects and other initiatives.

The University’s long-term investment strategy combined with its endowment spending policy serves to insulate operations from expected volatility in the capital markets and provides for a stable and predictable level of spending distributions from the endowment. Endowment spending rate distributions to University units totaled $296 million and $286 million in 2016 and 2015, respectively. The success of the University’s long-term investment strategy is evidenced by strong returns over sustained periods of time and the ability to limit losses in the face of challenging markets.

The University invests its financial assets in pools with distinct risk and liquidity characteristics based on its needs, with most of its financial assets invested in two such pools. The University’s working capital is primarily invested in relatively short duration, liquid assets, through its Daily and Monthly Portfolios, while the endowment is invested, along with the noncurrent portion of the insurance and benefit reserves, in an equity oriented long-term strategy through its Long Term Portfolio.

Using the Financial Statements

The University’s financial report includes three financial statements: the Statement of Net Position; the Statement of Revenues, Expenses and Changes in Net Position; 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.

Statement of Net Position

The statement of net position 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 position – is one indicator of the current financial condition of the University, while the change in net position is an indication of whether the overall financial condition has improved or worsened during the year. A comparison of the University’s assets, liabilities and net position at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in millions)	
Current assets	$ 2,445	$ 2,243
Noncurrent assets:		
Endowment, life income and other investments	10,046	10,264
Capital assets, net	5,709	5,622
Other	350	349
Total assets	18,550	18,478
Current liabilities	1,771	1,640
Noncurrent liabilities	3,778	3,542
Total liabilities	5,549	5,182
Net position	$ 13,001	$ 13,296

The University continues to maintain and protect its strong financial foundation. This financial health, as reflected in the statement of net position at June 30, 2016 and 2015, results from 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 and totaled $2.4 billion and $2.2 billion at June 30, 2016 and 2015, respectively. Cash, cash equivalents and investments for operating activities totaled $1.2 billion at June 30, 2016, which represents approximately two months of total expenses excluding depreciation.

Current liabilities consist primarily of accounts payable, accrued compensation, unearned revenue, commercial paper, the current portion of bonds payable and net long-term bonds payable subject to remarketing. Current liabilities totaled $1.8 billion and $1.6 billion at June 30, 2016 and 2015, respectively.

Endowment, Life Income and Other Investments

The composition of the University’s endowment, life income and other investments at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in millions)	
Endowment investments	$ 9,743	$ 9,952
Life income investments	111	111
Noncurrent portion of insurance and benefits obligations investments	192	201
	$ 10,046	$ 10,264

The University's endowment funds consist of both permanent endowments and funds functioning as endowment. Permanent endowments are those funds received from donors with the stipulation that the principal remain intact 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, a unitized pool which represents a collection of approximately 9,800 separate (individual) funds, the majority of which are restricted for specific purposes. The University Endowment Fund is invested in the University’s Long Term Portfolio, a single diversified investment pool.

The endowment spending rule provides for distributions from the University Endowment Fund to the units that benefit from the endowment fund. At June 30, 2016 and 2015, the annual distribution rate was 4.5 percent of the one-quarter lagged seven year moving average fair value of University Endowment Fund shares. The University’s endowment spending rule is one element of an ongoing financial management strategy that has allowed the University to effectively weather the challenging economic environment while avoiding measures such as faculty hiring freezes, furloughs, program cuts or halting construction.

To protect endowment principal in the event of a prolonged market downturn, distributions are limited to 5.3 percent of the current fair value of fund shares. Capital gains or income generated above the endowment spending rate are reinvested so that in lean times funds will be available for distribution. In addition, departments may also use withdrawals from funds functioning as endowment to support capital expenditures and operations.

Endowment spending rate distributions totaled $303 million, $292 million and $283 million and withdrawals from funds functioning as endowment totaled $60 million, $13 million and $137 million in 2016, 2015 and 2014, respectively. Total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 4.9 percent, 4.1 percent and 6.0 percent of the current year average fair value of the University Endowment Fund for 2016, 2015 and 2014, respectively. Over the past ten years, total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 5.0 percent.

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 maintain and modernize its existing infrastructure and strategically invest in new construction.

Capital asset additions totaled $595 million in 2016, as compared to $660 million in 2015. Capital asset additions primarily represent renovation and new construction of student residence, academic, research, clinical and athletic facilities, as well as significant investments in equipment, including information technology. Current year capital asset additions were primarily funded with net position and gifts designated for capital purposes of $364 million, as well as debt proceeds of $183 million and state capital appropriations of $48 million. Construction in progress, which totaled $452 million at June 30, 2016 and $529 million at June 30, 2015, includes important projects for student residential life, research, instruction, patient care and athletics.

Projects completed in 2016 include two significant residential projects. The construction and furnishing of the Munger Graduate Residences created a new state-of-the-art residence hall designed to foster a high level of diversity and interaction among graduate students studying across the University's 19 schools and colleges. By bringing together scholars with different approaches, this trans-disciplinary residence aims to break up the traditional silos of graduate work and foster greater collaboration to generate new ideas. The eight-story building is approximately 380,000 gross square feet and accommodates 630 students in an apartment-style layout.

Originally constructed in 1937, West Quadrangle, combined with the Cambridge House portion of the Michigan Union, underwent a renovation of approximately 370,000 gross square feet of space. With the creation of a central campus dining facility in nearby South Quad, the student dining facilities were repurposed to create space for living and learning activities to foster student interaction and community. The project also included infrastructure upgrades such as roof replacement, new plumbing, heating, cooling and ventilation systems, renovated student rooms and bath facilities and accessibility improvements.

Projects competed in 2016 also included construction of a new School of Nursing building of approximately 78,000 gross square feet to accommodate its instructional space needs. Key features of the building include active learning classrooms, a technologically rich clinical learning center with simulation and skills labs and simulated patient suites in an environment that will foster collaboration and community. This facility also includes offices for student services and a small number of faculty offices. The balance of the school’s offices and administration remain in the existing North Ingalls building.

Construction in progress at June 30, 2016 includes several significant academic renovation and construction projects. At the Ross School of Business, work continues on a new academic building to replace the Computer and Executive Education Building and a comprehensive renovation of Kresge Hall, formerly the Kresge Business Administration Library. In total, this project represents approximately 75,000 gross square feet of building renovation and 104,000 gross square feet of new building construction. The project will add classrooms, study space, and faculty research and office space as well as enhance non-academic operations to improve the student experience, with added space for student life functions, financial aid, admissions and onsite recruiting. Connecting the new building to existing buildings improves efficiencies throughout the school as well. Exterior building finishes are also being added to Sam Wyly Hall, the Business Administration Executive Dormitory and the Hill Street Parking Structure to create a welcoming and unified look for the entire Ross School complex of buildings. This project is scheduled to be completed in fall 2016.

A Biological Science Building of approximately 300,000 gross square feet is being constructed to provide a teaching, research and museum facility for the biological sciences and exhibit museums. Bringing these programs together under one roof will create exciting opportunities for interdisciplinary teaching, research and collaboration, and offer a richer experience for museum visitors. The new building will house classrooms, research laboratories, associated support functions, offices and vivarium services, as well as the anthropology, natural history, paleontology and zoology museums currently housed at the Alexander G. Ruthven Museums Building. The structure will also include a connection to the adjacent Life Sciences Institute Building to increase the utilization of its loading dock and vivarium functions. This project is scheduled to be completed in spring 2018.

Renovation of the Science Building on the University's Dearborn campus, which was originally constructed in 1959, is also underway. The renovation of this 80,000 gross square foot facility will provide updated laboratory and classroom space for the Department of Natural Sciences. In addition, approximately 20,000 gross square feet will be added to the building for state-of-the-art laboratory spaces, a new elevator, loading dock and mechanical penthouse. Infrastructure that is shared with the adjacent Computer Science Building is also being upgraded. The renewed facility will help transform science education and facilitate closer academic-industry and student-industry collaboration. This project is scheduled to be completed in fall 2016.

The University is aware of its financial stewardship responsibility and works diligently 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 June 2016, Moody's affirmed its highest credit rating (Aaa) for bonds backed by a broad revenue pledge based on the University's ability to translate its international brand into revenue growth and philanthropic support, and ongoing superior financial flexibility from robust financial reserves. Standard & Poor's also affirmed its highest credit rating (AAA) based on the University's robust enrollment and demand, exceptional student quality, retention and graduation rates, excellent balance sheet, exceptional research presence and manageable debt burden.

Long-term debt activity for the years ended June 30, 2016 and 2015 is summarized as follows:

	2016			
	Beginning Balance	Additions (in millions)	Reductions	Ending Balance
Commercial paper	$ 138	$ 197	$ 175	$ 160
Bonds	1,730	361	265	1,826
	$ 1,868	$ 558	$ 440	$ 1,986

	2015			
	Beginning Balance	Additions (in millions)	Reductions	Ending Balance
Commercial paper	$ 41	$ 137	$ 40	$ 138
Bonds	1,794		64	1,730
	$ 1,835	$ 137	$ 104	$ 1,868

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. Outstanding bonds are supported by the University's general revenues.

During 2016, consistent with capital and debt financing plans, the University issued $307 million of fixed rate, tax-exempt, general revenue bonds, with a net original issue premium of $54 million. Total bond proceeds of $361 million were utilized to convert $71 million of commercial paper to long-term debt, refund $205 million of General Revenue Bonds and provide $85 million for capital projects and debt issuance costs.

The composition of the University's debt at June 30, 2016 and 2015 is summarized as follows:

	2016	**2015**
	(in millions)	
Variable rate:		
Commercial paper	$ 160	$ 138
Bonds	611	833
Fixed rate bonds	1,215	897
	$ 1,986	$ 1,868

A significant portion of the University's variable rate bonds are subject to remarketing and, in accordance with GASB Interpretation No. 1, such debt is classified as current unless supported by liquidity arrangements such as lines of credit or standby bond purchase agreements, which could refinance the debt on a long-term basis. In the event that variable rate bonds are put back to the University by the debt holder, management believes that the University's strong credit rating will ensure that the bonds will be remarketed within a reasonable period of time. In addition, the University maintains five remarketing agents to achieve a wide distribution of its variable rate bonds.

While fixed rate bonds typically have a higher effective rate of interest at the date of issuance as compared to variable rate bonds, they reduce the volatility of required debt service payments and do not require liquidity support, such as lines of credit, standby bond purchase agreements or internal liquidity.

Effective interest rates averaged 2.3 percent in 2016 and 2.1 percent in 2015, including the federal subsidies for interest on taxable Build America Bonds. Interest expense net of federal subsidies received for interest on taxable Build America Bonds and interest capitalized during construction totaled $48 million in 2016 and $42 million in 2015.

Obligations for Postemployment Benefits

In accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, the University recognizes the cost of postemployment benefits during the periods when employees render their services. Using current actuarial assumptions, and presuming a continuation of the current level of benefits, the University's obligations for postemployment benefits totaled $1.84 billion and $1.75 billion at June 30, 2016 and 2015, respectively. Since a portion of retiree medical services will be provided by the University's Health System, this liability is net of the related margin and fixed costs of providing those services which totaled $394 million and $331 million at June 30, 2016 and 2015, respectively.

The University amortizes changes in actuarial assumptions, plan design and experience gains and losses over a ten-year closed period. Accordingly, the liability for net postemployment benefits obligations recorded in the statement of net position may differ from the actuarial accrued liability due to the unamortized portion of these changes. At June 30, 2016, the recorded liability for net postemployment benefits obligations totaled $1.84 billion and the actuarial accrued liability totaled $1.84 billion.

By implementing a series of health benefit initiatives over the past 11 years, the University has favorably impacted its actuarial accrued liability for postemployment benefits by $847 million as of June 30, 2016. These initiatives have included cost sharing changes, elimination of Medicare Part B reimbursements for certain retirees and the adjustment of retirement eligibility criteria. Conversely, in 2015, a reduction in the discount rate and the adoption of a new mortality table, unfavorably impacted the actuarial accrued liability by $344 million.

Net Position

Net position represents the residual interest in the University's assets after liabilities are deducted. The composition of the University's net position at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in millions)	
Net investment in capital assets	$ 3,821	$ 3,782
Restricted:		
Nonexpendable:		
Permanent endowment corpus	1,815	1,674
Expendable:		
Net appreciation of permanent endowments	1,519	1,708
Funds functioning as endowment	1,942	2,061
Restricted for operations and other	658	603
Unrestricted	3,246	3,468
	$ 13,001	$ 13,296

Net investment in capital assets represents the University's capital assets net of accumulated depreciation and outstanding principal balances of debt related to the acquisition, construction or improvement of those assets. The increase of $39 million in 2016 reflects the University's continued development and renewal of its capital assets in accordance with its long-range capital plan.

Restricted nonexpendable net position represents the historical value (corpus) of gifts to the University's permanent endowment funds. The increase of $141 million in 2016 primarily represents new gifts. Restricted expendable net position is subject to externally imposed stipulations governing their use and includes net appreciation of permanent endowments, funds functioning as endowment and net position restricted for operations, facilities and student loan programs. Restricted expendable net position totaled $4.1 billion at June 30, 2016, as compared to $4.4 billion at June 30, 2015, with the current year decline driven primarily by a decrease in net appreciation of permanent endowments resulting from investment losses.

Although unrestricted net position is not subject to externally imposed stipulations, substantially all of the University's unrestricted net position has been designated for various academic programs, research initiatives and capital projects. Unrestricted net position at June 30, 2016 totaled $3.2 billion and included funds functioning as endowment of $4.2 billion offset by unfunded obligations for postemployment benefits of $1.8 billion. Unrestricted net position at June 30, 2015 totaled $3.5 billion and included funds functioning as endowment of $4.3 billion offset by unfunded obligations for postemployment benefits of $1.7 billion. Unrestricted net position also includes other net resources which totaled $800 million and $900 million at June 30, 2016 and 2015, respectively.

Statement of Revenues, Expenses and Changes in Net Position

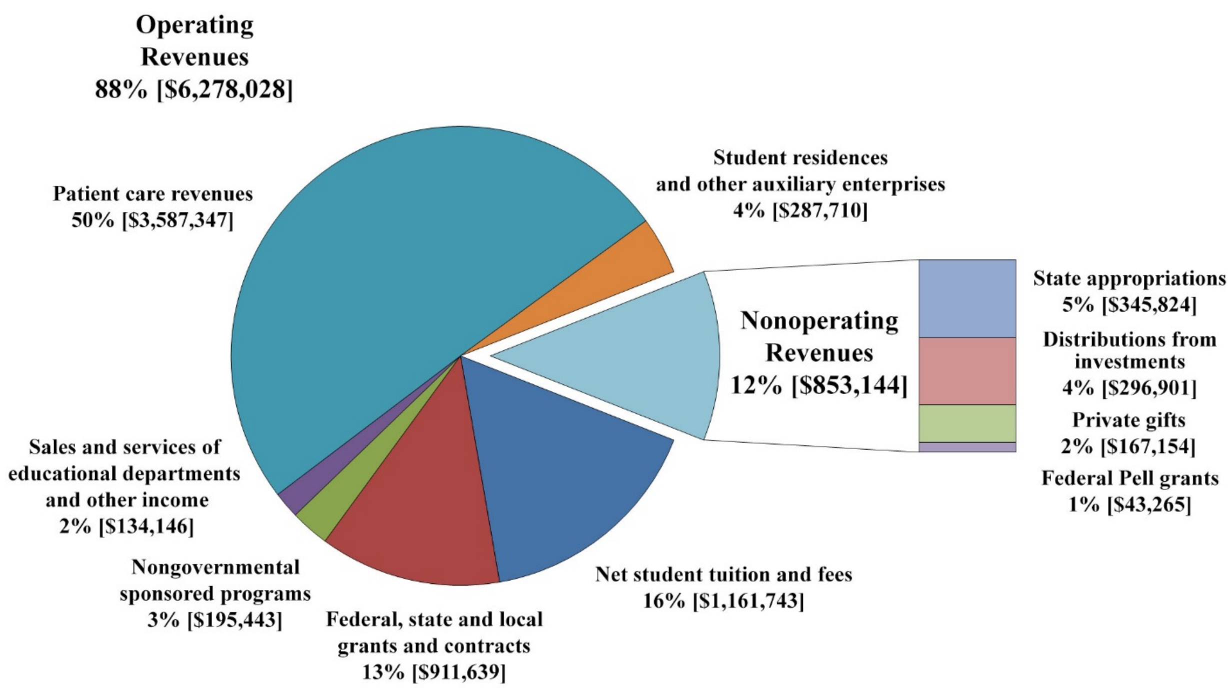
The statement of revenues, expenses and changes in net position presents the University's results of operations. In accordance with GASB reporting principles, revenues and expenses are classified as either operating or nonoperating. A comparison of the University's revenues, expenses and changes in net position for the three years ended June 30, 2016 is summarized as follows:

	2016	2015 (in millions)	2014
Operating revenues:			
Net student tuition and fees	$ 1,161.7	$ 1,145.9	$ 1,107.6
Sponsored programs	1,107.1	1,047.4	1,027.6
Patient care revenues, net	3,587.3	3,264.8	3,001.3
Other	421.9	465.3	398.4
	6,278.0	5,923.4	5,534.9
Operating expenses	7,152.8	6,693.2	6,381.3
Operating loss	(874.8)	(769.8)	(846.4)
Nonoperating and other revenues (expenses):			
State educational appropriations	345.8	340.2	321.7
Federal Pell grants	43.3	44.0	44.0
Private gifts for operating activities	167.2	172.0	166.4
Net investment (loss) income	(129.7)	357.8	1,653.8
Interest expense, net	(55.6)	(49.3)	(54.2)
Federal subsidies for interest on Build America Bonds	7.6	7.4	7.5
Endowment and capital gifts and grants	163.0	138.2	297.7
State capital appropriations	47.6	3.8	
Other	(9.0)	(6.6)	(15.5)
Nonoperating and other revenues, net	580.2	1,007.5	2,421.4
(Decrease) increase in net position	(294.6)	237.7	1,575.0
Net position, beginning of year	13,295.8	13,058.1	11,483.1
Net position, end of year	$ 13,001.2	$ 13,295.8	$ 13,058.1

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

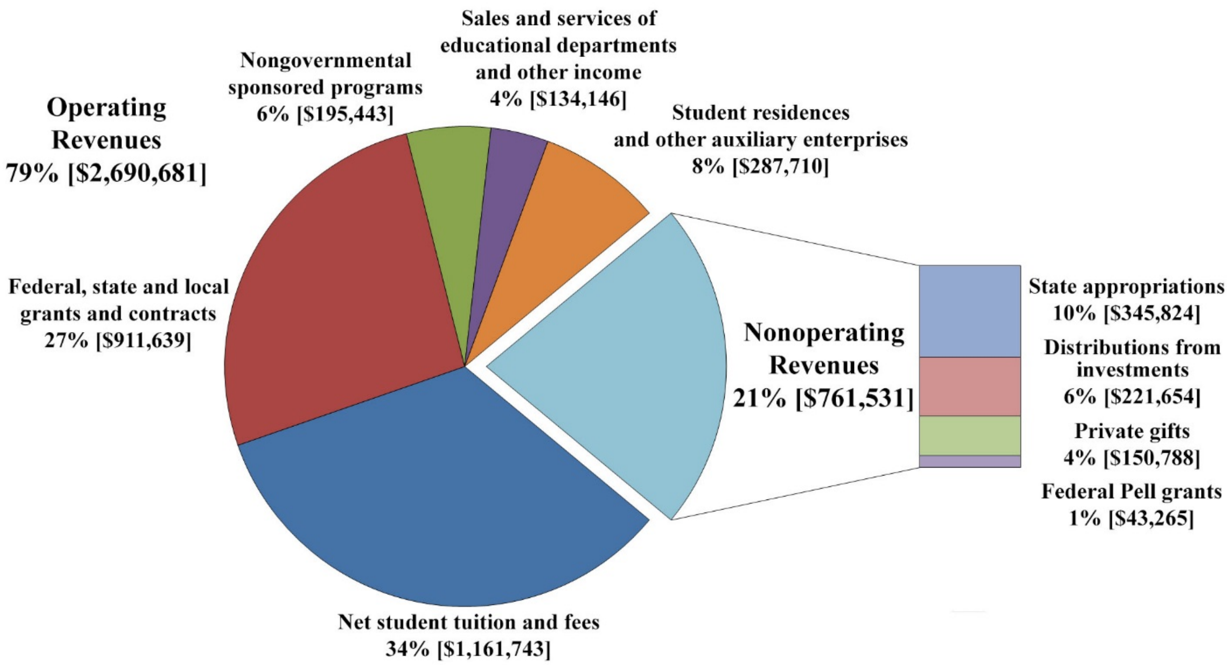
The following is a graphic illustration of revenues by source, both operating and nonoperating, which are used to fund the University's operating activities for the year ended June 30, 2016 (amounts are presented in thousands of dollars). Certain recurring sources of the University's revenues are considered nonoperating, as defined by GASB, such as state appropriations, distributions from investments, private gifts and federal Pell grants.

2016 Revenues for Operating Activities



The University measures its performance both for the University as a whole and for the University without its Health System and other clinical activities. The exclusion of these activities allows a clearer view of the operations of the schools and colleges, as well as 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 Health System and other clinical activities, for the year ended June 30, 2016 (amounts are presented in thousands of dollars).

2016 Revenues for Operating Activities
Excluding Revenues from the Health System and Other Clinical Activities



Tuition and state appropriations are the primary sources of funding for the University's academic programs. There is a 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 increased 1 percent, or $21 million, to $1.51 billion in 2016, as compared to 4 percent, or $57 million, to $1.49 billion in 2015.

The University has been able to avoid the severe cuts and double digit tuition increases experienced elsewhere in the country due to a prudent long-term plan which anticipated the realities of the state's challenging economy. The University's plan includes an ongoing commitment to cost containment and reallocating resources to the highest priorities to provide support for innovative new initiatives to maintain academic excellence and help students keep pace with the evolving needs of society.

In 2016, the University's state educational appropriations increased 2 percent, or $6 million, to $346 million. In 2015, the University's state educational appropriations increased 6 percent, or $18 million, to $340 million.

For the three years ended June 30, 2016, net student tuition and fees revenue consisted of the following components:

	2016	**2015** (in millions)	**2014**
Student tuition and fees	$ 1,502.2	$ 1,458.6	$ 1,405.3
Less scholarship allowances	340.5	312.7	297.7
	$ 1,161.7	$ 1,145.9	$ 1,107.6

In 2016, net student tuition and fees revenue increased 1 percent, or $16 million, to $1.16 billion, which reflects a 3 percent, or $44 million, increase in gross tuition and fee revenues offset by a 9 percent, or $28 million, increase in scholarship allowances. Tuition rate increases in 2016 were 2.7 percent for resident undergraduate students, 3.7 percent for nonresident undergraduate students and 2.7 percent for most graduate students on the Ann Arbor campus, with a 3.2 percent tuition rate increase for most undergraduate and graduate students on both the Dearborn and Flint campuses.

In 2015, net student tuition and fees revenue increased 3 percent, or $38 million, to $1.15 billion, which reflects a 4 percent, or $53 million, increase in gross tuition and fee revenues offset by a 5 percent, or $15 million, increase in scholarship allowances. Tuition rate increases in 2015 were 1.6 percent for resident undergraduate students, 3.4 percent for nonresident undergraduate students and 2.4 percent for most graduate students on the Ann Arbor campus, with a 3.2 percent tuition rate increase for most undergraduate and graduate students on the Dearborn campus and a 3.0 percent tuition rate increase for undergraduate and graduate students on the Flint campus.

During 2016 and 2015, the total number of students remained relatively stable; however, the University continued to experience a shift in mix from resident to non-resident students.

The University's tuition rate increases have consistently been among the lowest in the state, even in years of significant reductions in state appropriations, which reflects a commitment to affordable higher education for Michigan families. At the same time, the University has also increased scholarship and fellowship expenses and related allowances to benefit students in financial need.

While tuition and state appropriations fund a large percentage of University costs, private support is also essential to the University's academic distinction. Private gifts for other than capital and permanent endowment purposes totaled $167 million in 2016, as compared to $172 million in 2015 and $166 million in 2014.

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, with a significant portion related to federal research. Revenues for sponsored programs increased 6 percent, or $60 million, to $1.1 billion in 2016, driven primarily by an increase in federally sponsored activity. Revenues for sponsored programs increased 2 percent, or $20 million, to $1.0 billion in 2015, driven primarily by an increase in revenue from industry sponsored activities.

Patient care revenues are principally generated within the University's hospitals and ambulatory care facilities under contractual arrangements with governmental payers (Medicare and Medicaid) and private insurers. In 2016, the University's Hospitals and Health Centers ("HHC") realized payment rate increases from the majority of private insurers and governmental payers as compared to 2015 and 2014. The distribution of gross charge activity by primary payer source for the three years ended June 30, 2016 is summarized as follows:

	2016	**2015**	**2014**
Medicare	35.9%	35.6%	34.9%
Medicaid	16.7%	16.3%	15.1%
Blue Cross	32.6%	33.2%	34.0%
Other	14.8%	14.9%	16.0%

Patient care revenues increased 10 percent, or $323 million, to $3.6 billion in 2016, as compared to an increase of 9 percent, or $264 million, to $3.3 billion in 2015. The increased revenues for both years primarily resulted from growth in outpatient and inpatient volume, as well as an increase in revenue per patient case driven by favorable changes in payment rates. Adjusted cases, which is an aggregate activity measurement combining inpatient discharges and outpatient/observation case activity, increased 7 percent in 2016 and 2015 for HHC.

Net investment loss totaled $130 million in 2016, compared to net investment income of $358 million in 2015 and $1.7 billion in 2014. The investment environment in 2016 continued to be challenging and was characterized by high degree of volatility in the public equity and commodity sectors. The continued low interest rate environment and speculation as to whether higher rates are forthcoming has impacted asset classes within the portfolio in different ways. Both marketable equities and absolute return strategies suffered mid to high single-digit negative returns in 2016, while fixed income returns achieved high positive single-digit returns. Alternative investment results were mixed, with private equity and real estate leading with high single-digit returns. Venture capital returns were slightly negative and natural resources, although improved from the prior year, still returned double-digit losses. This compares to 2015 when the portfolio was characterized by relatively flat performance for the marketable securities with the alternative assets performing their role as a diversifier and delivering high single-digits returns. In 2014, returns were strong in fixed income, developed market equities, absolute return strategies and all alternative asset classes.

With the Victors for Michigan campaign well underway, gifts and grants for endowment and capital purposes continue to be a significant part of sustaining the University's excellence. Endowment and capital gifts and grants totaled $163 million in 2016, as compared to $138 million and $298 million in 2015 and 2014, respectively. Private gifts for permanent endowment purposes totaled $127 million in 2016, as compared to $115 million and $89 million in 2015 and 2014, respectively. Capital gifts and grants totaled $36 million in 2016, as compared to $23 million and $209 million in 2015 and 2014, respectively. In recent years, major gifts have been received in support of the University's wide-ranging capital initiatives which include graduate student housing, the Health System, Law School, Stephen M. Ross School of Business, College of Engineering and Intercollegiate Athletics.

State capital appropriations are also helping the University improve its academic buildings. Current capital outlays are supporting renovations of the George Granger Brown Memorial Laboratories on the Ann Arbor campus, the Science Building and Computer Information Science Building on the Dearborn campus and the William R. Murchie Science Building on the Flint campus. Revenue is recognized as qualified capital expenditures are incurred and totaled $48 million in 2016 and $4 million in 2015.

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 pressures, particularly in the areas of compensation and benefits, which represent 64 percent of total expenses, as well as in the areas of energy, technology and ongoing maintenance of facilities and infrastructure.

A comparative summary of the University's expenses for the three years ended June 30, 2016 is as follows (amounts in millions):

	2016		2015		2014	
Operating:						
Compensation and benefits	$ 4,627.4	64%	$ 4,330.9	64%	$ 4,150.8	64%
Supplies and services	1,891.6	26	1,735.9	26	1,618.5	25
Depreciation	501.6	7	493.6	7	487.5	8
Scholarships and fellowships	132.2	2	132.8	2	124.5	2
	7,152.8	99	6,693.2	99	6,381.3	99
Nonoperating:						
Interest, net	48.0	1	41.9	1	46.7	1
	$ 7,200.8	100%	$ 6,735.1	100%	$ 6,428.0	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 7 percent, or $297 million, to $4.6 billion in 2016, as compared to 4 percent, or $180 million, to $4.3 billion in 2015. Of the 2016 increase, compensation increased 5 percent, to $3.5 billion, and employee benefits increased 14 percent, to $1.1 billion, with the increase in employee benefits driven primarily by a change in the underlying mortality and discount rate assumptions used to develop the recorded liability for postemployment benefits. For 2015, compensation increased 5 percent, to $3.4 billion, and employee benefits increased 2 percent, to $962 million. During 2016 and 2015, nursing and other health professionals were added to support higher patient volume levels.

The University faces external and industry realities that put significant pressure on its ability to reduce compensation costs while remaining competitive. To help address this risk, the University continues to review components of its existing benefits program to find opportunities for potential savings without compromising the ability to offer competitive benefits to all faculty and staff.

Effective January 1, 2015, the University changed its defined contribution retirement plan to use base pay alone as eligible pay for calculating plan contributions. Elements of salary beyond base pay such as administrative and added-duties differentials, one-time lump sum payments, overtime pay and payout of unused vacation time upon termination will now be excluded from retirement savings calculations. Additionally, University contributions to the plan for certain employees of its health system were reduced to a cap of 9 percent from 10 percent of eligible pay to better align these benefits with those offered within the health care industry. All employees participating in the University's retirement savings plans continue to have the option to save additional base pay via a supplemental retirement account on a pre-tax basis.

Health care benefits are one of the most significant employee benefits. Over the past several years, the University has implemented initiatives to better control its rate of cost increase, encourage employees to choose the lowest cost health care plan that meets their needs and share a larger portion of health care cost increases with employees.

Compared to most employers, the University is in a unique position to utilize internal experts to advise and guide its health care and drug plans. For example, the Pharmacy Benefits Advisory Committee, which consists of internal experts including Health System physicians, School of Pharmacy faculty and on-staff pharmacists, monitors the safety and effectiveness of covered medications and guides appropriate prescribing, dispensing and cost effective use of prescription drugs. In addition, the University utilizes its nationally recognized health policy experts to guide future health plan strategies.

During 2013, the University began to implement changes to eligibility requirements and the University contribution to retiree health benefits that were announced in 2011. These changes were recommended by a committee that evaluated ways to maintain competitive retiree health benefits while helping address the acceleration of future costs. The changes are being phased in over eight years in order to assist current employees with the transition.

The University utilizes a point system to determine retirement eligibility, where points represent the combination of age and years of service for full-time employees. The points needed to retire with health benefits will gradually be increased from 76 in 2013 to 80 in 2021. Over the same period, the University’s contribution towards health care benefits will gradually decrease from 87.5 percent for the retiree and 65 percent for any dependents for employees who retire in 2013 to a maximum of 80 percent for the retiree and 50 percent for any dependents for employees who retire in 2021. Employees who retire after December 31, 2020 will need a minimum of 20 years of service to receive the maximum contribution upon retirement which will be 68 percent for the retiree and 26 percent for any dependents. These adjustments will keep the University’s retiree benefits competitive with peer institutions while producing an estimated $9 million reduction in annual cash outlay by 2020 and an estimated $165 million reduction in annual cash outlay by 2040.

The University continues to monitor and evaluate the cost of employee and retiree health benefits, following key benchmarks to ensure competitiveness with local and national higher education and health care markets. As national health care reforms are implemented under the Affordable Care Act, the University is closely tracking cost and coverage implications. Careful stewardship of our health benefit plans helps maintain our competitive position while preserving funding for the University’s core mission.

The MHealthy initiative is a University-wide effort to improve the health and well-being of faculty, staff and their dependents by creating a culture of health and reducing or preventing health risks in our population. A five-year review of the program conducted in 2015 noted that overall annual program participation has been stable, with over 20,000 employees. Over the five-year period, decreases in the percentage of high risk employees occurred in many risk areas including back pain, alcohol, tobacco, nutrition and physical activity.

These initiatives and programs reflect the reality of the national landscape, while remaining true to the commitment we make to our employees for a robust benefits package.

Supplies and services expenses increased 9 percent, or $156 million, to $1.9 billion in 2016, as compared to an increase of 7 percent, or $117 million, to $1.7 billion in 2015. These increases were primarily due to growth in patient care related expenses including higher costs of prescription drugs and surgical implants, as well as costs associated with significant capital projects. During 2014, the new Northville Health Center facility was placed in service and the University implemented several significant information technology systems, including the third phase of an electronic medical record and patient billing system.

Depreciation expense increased 2 percent, or $8 million, to $502 million in 2016, as compared to an increase of 1 percent, or $6 million, to $494 million in 2015. The increased depreciation expense is primarily related to the completion of current year capital projects, as well as the impact of a full year of depreciation for the capital projects completed during the prior year. Capital assets placed in service during 2016 include the renovation of the West Quadrangle and Michigan Union-Cambridge House, as well as new construction of the Munger Graduate Residences and an instructional building for the School of Nursing. Capital assets placed in service in 2015 include the renovation and expansion of South Quad, the A. Alfred Taubman Health Sciences Library buildings and the Phyllis Ocker Field Hockey Stadium.

Net interest expense increased $6 million in 2016 to $48 million, from $42 million in 2015 and $47 million in 2014.

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, 2016 is as follows (amounts in millions):

	2016		2015		2014	
Operating:						
Instruction	$ 1,031.0	14%	$ 983.5	15%	$ 953.9	15%
Research	754.8	10	706.1	10	708.8	11
Public service	182.2	3	189.4	3	152.8	2
Institutional and academic support	623.0	9	581.5	9	542.9	8
Auxiliary enterprises:						
Patient care	3,402.5	47	3,127.1	46	2,925.0	46
Other	218.5	3	201.5	3	208.5	3
Operations and maintenance of plant	307.0	4	277.7	4	277.4	4
Depreciation	501.6	7	493.6	7	487.5	8
Scholarships and fellowships	132.2	2	132.8	2	124.5	2
	7,152.8	99	6,693.2	99	6,381.3	99
Nonoperating:						
Interest, net	48.0	1	41.9	1	46.7	1
	$ 7,200.8	100%	$ 6,735.1	100%	$ 6,428.0	100%

Instruction expenses increased 5 percent, or $48 million in 2016, and 3 percent, or $30 million in 2015. This increase is consistent with the modest level of growth in the related revenue sources offset by cost containment efforts.

Research expenses increased 7 percent, or $49 million in 2016, and decreased 0.4 percent, or $3 million in 2015. The increase in 2016 reflects the strength of the University’s research enterprise, in spite of continued pressure from sequestration and intense competition for research dollars. 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 totaled $1.4 billion, $1.3 billion and $1.3 billion in 2016, 2015 and 2014, respectively.

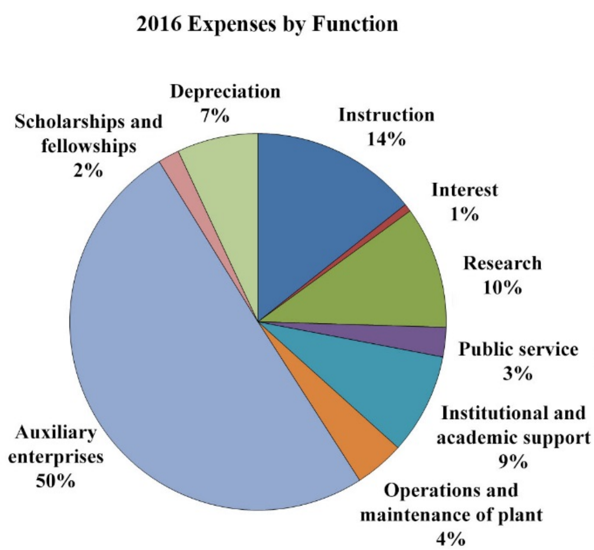
Patient care expenses increased 9 percent, or $275 million in 2016, and 7 percent, or $202 million in 2015. These increases are the result of additional patient care volume, including costs of staffing, medical supplies and pharmaceuticals.

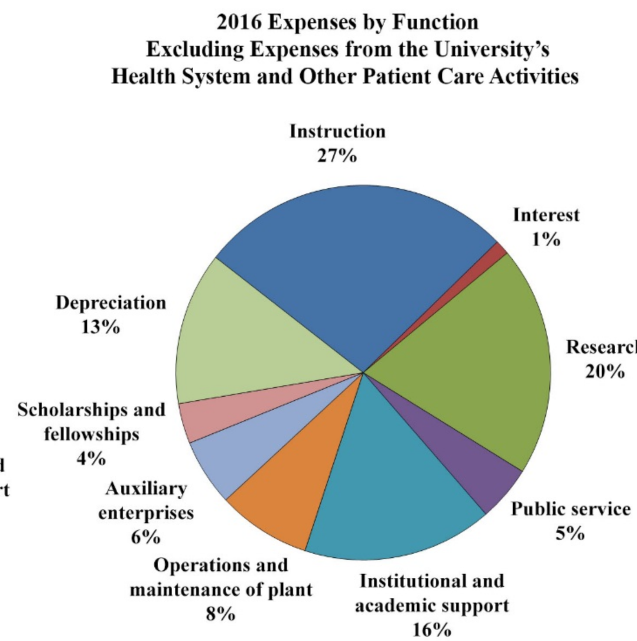
Management's Discussion and Analysis (Unaudited)--Continued

Total scholarships and fellowships provided to students aggregated $494 million in 2016, as compared to $465 million in 2015 and $441 million in 2014, an increase of 12 percent over the past two years. 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 expenses. Scholarships and fellowships for the three years ended June 30, 2016 are summarized as follows:

	2016	2015 (in millions)	2014
Paid directly to students	$ 132.2	$ 132.8	$ 124.5
Applied to tuition and fees	340.5	312.7	297.7
Applied to University Housing	21.6	19.8	18.6
	$ 494.3	$ 465.3	$ 440.8

The following graphic illustrations present total expenses by function, with and without the University's Health System and other patient care activities:





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, 2016 and 2015 is as follows:

	2016	2015
	(in millions)	
Cash received from operations	$ 6,330.7	$ 5,943.7
Cash expended for operations	(6,496.5)	(6,238.8)
Net cash used in operating activities	(165.8)	(295.1)
Net cash provided by investing activities	116.4	291.0
Net cash used in capital and related financing activities	(449.3)	(617.0)
Net cash provided by noncapital financing activities	679.0	660.8
Net increase in cash and cash equivalents	180.3	39.7
Cash and cash equivalents, beginning of year	105.5	65.8
Cash and cash equivalents, end of year	$ 285.8	$ 105.5

Cash received from operations primarily consists of student tuition, sponsored program grants and contracts and patient care revenues. Significant sources of cash provided by noncapital financing activities, as defined by GASB, include state appropriations, federal Pell grants and private gifts used to fund operating activities.

Economic Factors That Will Affect the Future

The University continues to face significant financial challenges to its academic programs, stemming from the State's uncertain financial circumstances. Given the continuation of this difficult economic environment, it is noteworthy that the University maintains the highest credit ratings of Moody's (Aaa) and Standard & Poor's (AAA). Achieving and maintaining the highest credit ratings provides the University with significant 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 a consistent level of excellence in service to students, patients, the research community, the state and the nation.

A crucial element to the University's future continues to be a strong relationship with the state of Michigan. Historically, there has been a connection between the growth, or reduction, of state support and the University's ability to control tuition increases. Over the past several years, the University has successfully addressed the realities of the state's difficult economy and, pursuant to a long-range plan, continues to work relentlessly to cut and mitigate operational costs in order to remain affordable and preserve access, while protecting the academic enterprise.

The University's budget for 2017 anticipates a 3.0 percent increase in state educational appropriations, a 3.9 percent tuition rate increase for Ann Arbor campus resident undergraduates and a 10.8 percent increase in centrally awarded financial aid. Nonresident undergraduate tuition rates will increase 4.4 percent, while most graduate and professional rates will increase 3.9 percent. Resident undergraduate tuition rates on the Dearborn and Flint campuses will increase 4.1 percent.

While tuition and state appropriations fund a large percentage of academic costs, private support is also essential to the University's academic distinction. In November 2013, the University launched the public phase of a major fundraising campaign with the announcement of an ambitious goal of $4 billion. The campaign, titled "Victors for Michigan", is focused on raising funds for three priority areas of student support, engaged learning and bold ideas, in order to better prepare tomorrow's leaders and address the complex problems facing the world. Since commencing the quiet phase of the campaign in 2011, the University has raised 87.5 percent of the goal, in cash, pledges and bequests. The campaign will continue through 2018.

The University continues to execute its long-range plan to maintain, modernize and expand its complement of older facilities while adding key new facilities for instruction, research, patient care and residential life. This strategy addresses the University's growth and the continuing effects of technology on teaching, research and clinical activities. Authorized costs to complete construction and other projects totaled $1.1 billion at June 30, 2016. Funding for these projects is anticipated to include $1.0 billion from internal sources, gifts, grants and future borrowings, $26 million from the State Building Authority and $36 million from the utilization of unexpended debt proceeds.

In addition to strategic capital and technological investments, the University's Health System is also focusing on clinical affiliation arrangements to enhance patient care, clinical research, physician recruitment and support services. In support of this goal, the University signed a definitive agreement in September 2016 in connection with a proposed affiliation with Metropolitan Health Corporation ("Metro Health"), a community health care provider in west Michigan. In addition to its 208-bed hospital, Metro Health has neighborhood outpatient centers and offices throughout west Michigan to serve the greater Grand Rapids area.

While HHC is 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.

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.

As a labor-intensive organization, the University faces competitive pressures related to attracting and retaining faculty and staff. Moreover, consistent with the national landscape, the University also faces rising costs of health benefits for its employees and retirees. The University has successfully taken and will continue to take proactive steps to respond to these challenges while protecting the quality of the overall benefits package.

U.S. health care reform will also continue to influence benefits planning. Since the Affordable Care Act was signed into law in March 2010 and subsequently affirmed by the Supreme Court, new regulatory requirements continue to affect health plans, providers and employers alike. Beginning in 2011, the University has implemented several initiatives in response to this new law including required cost-sharing, eligibility and communications changes. University experts are continuing to assess additional health care reform impacts, including health insurance exchanges for large employers in 2017 and the excise tax on high-cost plans in 2020. As of January 1, 2016, the University was required to offer minimum essential health coverage to 95 percent of its full time employees regardless of regular or temporary status. The University is working to develop clear strategies and options for the future that will ensure compliance over the coming years of regulatory change.

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

UNIVERSITY OF MICHIGAN

Consolidated Statement of Net Position

	June 30, 2016	June 30, 2015
	(in thousands)	
Assets		
Current Assets:		
Cash and cash equivalents	**$ 285,838**	$ 105,465
Investments for operating activities	**919,270**	957,915
Investments for capital activities	**320,934**	294,013
Investments for student loan activities	**57,273**	55,751
Accounts receivable, net	**615,969**	580,291
Current portion of notes and pledges receivable, net	**73,958**	79,445
Current portion of prepaid expenses and other assets	**108,834**	86,581
Cash collateral held by agent	**63,292**	83,203
Total Current Assets	**2,445,368**	2,242,664
Noncurrent Assets:		
Endowment, life income and other investments	**10,045,608**	10,264,326
Notes and pledges receivable, net	**318,278**	321,639
Prepaid expenses and other assets	**32,685**	27,101
Capital assets, net	**5,708,576**	5,622,386
Total Noncurrent Assets	**16,105,147**	16,235,452
Total Assets	**$ 18,550,515**	$ 18,478,116
Liabilities and Net Position		
Current Liabilities:		
Accounts payable	**$ 292,817**	$ 232,110
Accrued compensation and other	**416,099**	365,789
Unearned revenue	**265,563**	228,144
Current portion of insurance and benefits reserves	**90,791**	84,634
Current portion of obligations for postemployment benefits	**74,885**	65,172
Commercial paper and current portion of bonds payable	**292,021**	201,146
Long-term bonds payable subject to remarketing, net	**217,637**	336,374
Collateral held for securities lending	**63,292**	83,203
Deposits of affiliates and others	**58,258**	43,890
Total Current Liabilities	**1,771,363**	1,640,462
Noncurrent Liabilities:		
Accrued compensation	**50,411**	53,606
Insurance and benefits reserves	**112,412**	108,271
Obligations for postemployment benefits	**1,765,698**	1,687,691
Obligations under life income agreements	**58,272**	46,570
Government loan advances	**87,630**	87,483
Bonds payable	**1,476,712**	1,330,897
Deposits of affiliates and other	**226,762**	227,329
Total Noncurrent Liabilities	**3,777,897**	3,541,847
Total Liabilities	**5,549,260**	5,182,309
Net Position:		
Net investment in capital assets	**3,820,905**	3,782,130
Restricted:		
Nonexpendable	**1,815,575**	1,673,996
Expendable	**4,119,019**	4,371,607
Unrestricted	**3,245,756**	3,468,074
Total Net Position	**13,001,255**	13,295,807
Total Liabilities and Net Position	**$ 18,550,515**	$ 18,478,116

The accompanying notes are an integral part of the consolidated financial statements.

UNIVERSITY OF MICHIGAN

Consolidated Statement of Revenues, Expenses and Changes in Net Position

	Year Ended June 30, 2016	2015
	(in thousands)	
Operating Revenues		
Student tuition and fees	**$ 1,502,202**	$ 1,458,576
Less scholarship allowances	**340,459**	312,659
Net student tuition and fees	**1,161,743**	1,145,917
Federal grants and contracts	**900,778**	845,263
State and local grants and contracts	**10,861**	7,925
Nongovernmental sponsored programs	**195,443**	194,219
Sales and services of educational departments	**131,081**	193,487
Auxiliary enterprises:		
Patient care revenues (net of provision for bad debts of $101,799 in 2016 and $124,783 in 2015)	**3,587,347**	3,264,832
Student residence fees (net of scholarship allowances of $21,640 in 2016 and $19,825 in 2015)	**107,028**	98,221
Other revenues	**180,682**	170,631
Student loan interest income and fees	**3,065**	2,879
Total Operating Revenues	**6,278,028**	5,923,374
Operating Expenses		
Compensation and benefits	**4,627,415**	4,330,909
Supplies and services	**1,891,519**	1,735,922
Depreciation	**501,631**	493,629
Scholarships and fellowships	**132,228**	132,758
Total Operating Expenses	**7,152,793**	6,693,218
Operating loss	**(874,765)**	(769,844)
Nonoperating Revenues (Expenses)		
State educational appropriations	**345,824**	340,201
Federal Pell grants	**43,265**	44,061
Private gifts for other than capital and endowment purposes	**167,154**	171,952
Net investment (loss) income	**(129,669)**	357,780
Interest expense, net	**(55,564)**	(49,288)
Federal subsidies for interest on Build America Bonds	**7,565**	7,443
Total Nonoperating Revenues, Net	**378,575**	872,149
(Loss) income before other revenues (expenses)	**(496,190)**	102,305
Other Revenues (Expenses)		
State capital appropriations	**47,566**	3,847
Capital gifts and grants	**36,439**	22,975
Private gifts for permanent endowment purposes	**126,630**	115,203
Other	**(8,997)**	(6,597)
Total Other Revenues, Net	**201,638**	135,428
(Decrease) increase in net position	**(294,552)**	237,733
Net Position, Beginning of Year	**13,295,807**	13,058,074
Net Position, End of Year	**$ 13,001,255**	$ 13,295,807

The accompanying notes are an integral part of the consolidated financial statements.

UNIVERSITY OF MICHIGAN

Consolidated Statement of Cash Flows

	Year Ended June 30, 2016	2015
	(in thousands)	
Cash Flows From Operating Activities		
Student tuition and fees	**$ 1,166,315**	$ 1,141,704
Federal, state and local grants and contracts	**902,253**	840,144
Nongovernmental sponsored programs	**201,683**	201,852
Sales and services of educational departments and other	**340,514**	354,555
Patient care revenues	**3,588,770**	3,284,591
Student residence fees	**108,481**	98,801
Payments to employees	**(3,511,163)**	(3,374,825)
Payments for benefits	**(1,006,801)**	(936,342)
Payments to suppliers	**(1,826,563)**	(1,771,937)
Payments for scholarships and fellowships	**(132,228)**	(132,758)
Student loans issued	**(19,730)**	(22,942)
Student loans collected	**19,656**	19,206
Student loan interest and fees collected	**3,065**	2,879
Net Cash Used in Operating Activities	**(165,748)**	(295,072)
Cash Flows From Investing Activities		
Interest and dividends on investments, net	**77,309**	50,605
Proceeds from sales and maturities of investments	**4,809,747**	5,763,848
Purchases of investments	**(4,670,131)**	(5,530,132)
Net (increase) decrease in cash equivalents from noncurrent investments	**(109,039)**	5,701
Net increase in deposits of affiliates and other	**8,532**	968
Net Cash Provided by Investing Activities	**116,418**	290,990
Cash Flows From Capital and Related Financing Activities		
State capital appropriations	**27,494**	
Private gifts and other receipts	**43,397**	44,154
Proceeds from issuance of capital debt	**558,249**	136,915
Principal payments on capital debt	**(437,000)**	(100,640)
Interest payments on capital debt	**(57,652)**	(54,801)
Federal subsidies for Build America Bonds interest	**7,545**	7,603
Payments for bond refunding and related costs	**(911)**	
Purchases of capital assets	**(591,336)**	(652,241)
Proceeds from sales of capital assets	**898**	1,995
Net Cash Used in Capital and Related Financing Activities	**(449,316)**	(617,015)
Cash Flows From Noncapital Financing Activities		
State educational appropriations	**344,802**	336,834
Federal Pell grants	**43,265**	44,061
Private gifts and other receipts	**298,926**	277,284
Student direct lending receipts	**281,898**	304,656
Student direct lending disbursements	**(292,106)**	(303,638)
Amounts received for annuity and life income funds	**9,743**	9,136
Amounts paid to annuitants and life beneficiaries and related expenses	**(7,509)**	(7,533)
Net Cash Provided by Noncapital Financing Activities	**679,019**	660,800
Net increase in cash and cash equivalents	**180,373**	39,703
Cash and Cash Equivalents, Beginning of Year	**105,465**	65,762
Cash and Cash Equivalents, End of Year	**$ 285,838**	$ 105,465

The accompanying notes are an integral part of the consolidated financial statements.

UNIVERSITY OF MICHIGAN

Consolidated Statement of Cash Flows--Continued

	Year Ended June 30, 2016	2015
	(in thousands)	
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	**$ (874,765)**	$ (769,844)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation expense	**501,631**	493,629
Changes in assets and liabilities:		
Accounts receivable, net	**(4,440)**	(13,716)
Prepaid expenses and other assets	**(9,425)**	(19,257)
Accounts payable	**65,143**	(16,927)
Accrued compensation and other	**20,671**	261
Unearned revenue	**37,419**	11,132
Insurance and benefits reserves	**10,298**	(1,759)
Obligations for postemployment benefits	**87,720**	21,409
Net cash used in operating activities	**$ (165,748)**	$ (295,072)

The accompanying notes are an integral part of the consolidated financial statements.

Note 1--Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation: The University of Michigan (the "University") is a state-supported institution with an enrollment of over 61,000 students on its three campuses. The financial statements include the individual schools, colleges and departments, the University of Michigan Hospitals and Health Centers, Michigan Health Corporation (a wholly-owned corporation created to pursue joint venture and managed care initiatives) and Veritas Insurance Corporation (a wholly-owned captive insurance company). While the University is a political subdivision of the state of Michigan, it is not a component unit of the State in accordance with Governmental Accounting Standards Board ("GASB") Statement No. 14, *The Financial Reporting Entity*. The University is classified as a state instrumentality under Internal Revenue Code Section 115 and a charitable organization under Internal Revenue Code Section 501(c)(3), and is therefore exempt from federal income taxes. Certain activities of the University may be subject to taxation as unrelated business income under Internal Revenue Code Sections 511 to 514.

The University reports as a special purpose government entity engaged primarily in business type activities, as defined by GASB, on the accrual basis. Business type activities are those that are financed in whole or in part by fees charged to external parties for goods or services.

The financial statements of all controlled organizations are included in the University's financial statements; affiliated organizations that are not controlled by, and not dependent on the University, such as booster and alumni organizations, are not included.

Net position is categorized as:

- Net investment in capital assets: Capital assets, net of accumulated depreciation and outstanding principal balances of debt related to the acquisition, construction or improvement of those assets.

- Restricted:

  Nonexpendable – Net position subject to externally imposed stipulations that it be maintained permanently. Such net position includes the corpus portion (historical value) of gifts to the University's permanent endowment funds and certain investment earnings stipulated by the donor to be reinvested permanently.

  Expendable – Net position subject to externally imposed stipulations that can be fulfilled by actions of the University pursuant to those stipulations or that expire by the passage of time. Such net position includes net appreciation of the University's permanent endowment funds that have not been stipulated by the donor to be reinvested permanently.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

- Unrestricted: Net position not subject to externally imposed stipulations. Unrestricted net position may be designated for specific purposes by action of management or the Board of Regents. Substantially all unrestricted net position is designated for various academic programs, research initiatives and capital projects.

Adoption of New Accounting Standard: During 2016, the University adopted GASB Statement No. 72, *Fair Value Measurement and Application* ("GASB 72"). With the adoption of this statement, the University expanded disclosures to present cash equivalents, investments and derivative instruments across the hierarchy of valuation inputs.

Accounting Standard Issued But Not Yet Adopted: In June 2015, the GASB issued Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions,* which establishes new accounting and financial reporting requirements for the University's postemployment benefits. This statement is effective for fiscal years beginning after June 15, 2017 and the University is currently evaluating the potential impact to its financial statements and related disclosures.

Summary of Significant Accounting Policies: For purposes of the statement of cash flows, the University considers all highly liquid investments purchased with a maturity of three months or less, to be cash equivalents. Cash equivalents representing assets of the University's endowment, life income and other investments are included in noncurrent investments as these funds are not used for operating purposes.

Investments are reported in four categories in the statement of net position. Investments reported as endowment, life income and other investments are those funds invested in portfolios that are considered by management to be of a long duration. Investments for student loan and capital activities are those funds that are intended to be used for these specific activities. All other investments are reported as investments for operating activities.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

GASB 72 defines fair value and establishes a framework for measuring fair value that includes a three tiered hierarchy of valuation inputs, placing a priority on those which are observable in the marketplace. Observable inputs reflect market data obtained from sources independent of the reporting entity and unobservable inputs reflect the University's own assumptions about how market participants would value an asset or liability based on the best information available. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. The three levels of inputs, of which the first two are considered observable and the last unobservable, are as follows:

- Level 1 – Quoted prices for identical assets or liabilities in active markets that can be accessed at the measurement date

- Level 2 – Other significant observable inputs, either direct or indirect, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable; or market corroborated inputs

- Level 3 – Unobservable inputs

GASB 72 allows for the use of net asset value ("NAV") as a practical expedient for valuation purposes. Investments that use NAV in determining fair value are disclosed separately from the valuation hierarchy as presented in Note 2.

Investments in marketable securities are carried at fair value, as established by the major securities markets. Purchases and sales of investments are accounted for on the trade date basis. Investment income is recorded on the accrual basis. Realized and unrealized gains and losses are reported in investment income.

Investments in nonmarketable limited partnerships are carried at fair value, which is generally established using the NAV provided by the management of the investment partnerships as of June 30, 2016 and 2015. The University may also adjust the fair value of these investments based on market conditions, specific redemption terms and restrictions, risk considerations and other factors. As these investments are not readily marketable the estimated value is subject to uncertainty, and therefore, may differ from the value that would have been used had a ready market for the investments existed.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

Investments denominated in foreign currencies are translated into U.S. dollar equivalents using year-end spot foreign currency exchange rates. Purchases and sales of investments denominated in foreign currencies and related income are translated at spot exchange rates on the transaction dates.

Derivative instruments such as financial futures, forward foreign exchange contracts and interest rate swaps held in investment portfolios, are recorded on the contract date and are carried at fair value using listed price quotations or amounts that approximate fair value. To facilitate trading in financial futures, the University is required to post cash or securities to satisfy margin requirements of the exchange where such futures contracts are listed. The University monitors the required amount of cash and securities on deposit for financial futures transactions and withdraws or deposits cash or securities as necessary.

Accounts receivable are recorded net of an allowance for uncollectible accounts receivable. The allowance is based on management's judgment of potential uncollectible amounts, which includes such factors as historical experience and type of receivable.

The University receives pledges and bequests of financial support from corporations, foundations and individuals. Revenue is recognized when a pledge representing an unconditional promise to pay is received and all eligibility requirements, including time requirements, have been met. In the absence of such a promise, revenue is recognized when the gift is received. Permanent endowment pledges do not meet eligibility requirements, as defined by GASB, and are not recorded as assets until the related gift is received.

Unconditional promises to give that are expected to be collected in future years are recorded at the present value of the estimated future cash flows. The discounts on these amounts are computed using risk-free interest rates applicable to the years in which the promises are made, commensurate with expected future payments. An allowance for uncollectible pledges receivable is provided based on management's judgment of potential uncollectible amounts and includes such factors as prior collection history, type of gift and nature of fundraising.

Capital assets are recorded at cost or, if donated, at fair value at the date of donation. Depreciation of capital assets is provided on a straight-line method over the estimated useful lives of the respective assets, which generally range from four to forty years. The University does not capitalize works of art or historical treasures 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.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

Unearned revenue consists primarily of cash received from grant and contract sponsors which has not yet been earned under the terms of the agreement. Unearned revenue also includes amounts received in advance of an event, such as student tuition and advance ticket sales related to future fiscal years.

Deposits of affiliates and others represent cash and invested funds held by the University as a result of agency relationships with various groups. Noncurrent deposits of affiliates represent the portion of endowment and similar funds held by the University on behalf of others.

The University holds life income funds for beneficiaries of the pooled income fund, charitable remainder trusts and the gift annuity program. These funds generally pay lifetime income to beneficiaries, after which the principal is made available to the University in accordance with donor intentions. All life income fund assets, including those held in trust, are recorded at fair value. The present value of estimated future payments due to life income beneficiaries is recorded as a liability.

For donor restricted endowments, the Uniform Prudent Management of Institutional Funds Act, as adopted in Michigan, permits the Board of Regents to appropriate amounts for endowment spending rule distributions as is considered prudent. The University's policy is to retain net realized and unrealized appreciation with the endowment after spending rule distributions. Net appreciation of permanent endowment funds, which totaled $1,519,149,000 and $1,708,175,000 at June 30, 2016 and 2015, respectively, is recorded in restricted expendable net position. The University's endowment spending rule is further discussed in Note 2.

Student tuition and residence fees are presented net of scholarships and fellowships applied to student accounts, while stipends and other payments made directly to students are presented as scholarship and fellowship expenses.

Patient care revenues are reported net of contractual allowances and bad debt expenses. Contractual allowances are estimated based on agreements with third-party payers that provide payments for patient care services at amounts different from established rates. These allowances are subject to the laws and regulations governing the federal and state programs and post-payment audits, and adjusted in future periods as final settlements are determined. Patient care services are primarily provided through the University of Michigan Health System, which includes the Hospitals and Health Centers, the University of Michigan Medical Group and the Michigan Health Corporation. Patient care services are also provided through University Health Services, which provides health care services to students, faculty and staff, and Dental Faculty Associates, which provides dental care services performed by faculty dentists.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

Patient care services are provided to patients who meet certain criteria under the Hospitals and Health Centers' charity care policy without charge or at amounts less than its established rates. Accordingly, charity care is not reported as revenue in the accompanying statement of revenues, expenses and changes in net position. Charges forgone for charity care services totaled $48,203,000 and $20,557,000 in 2016 and 2015, respectively.

Other auxiliary enterprise revenues primarily represent revenues generated by intercollegiate athletics, parking, student unions and student publications.

The University's policy for defining operating activities as reported on the statement of revenues, expenses and changes in net position are those that generally result from exchangetransactions 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 result from nonexchange transactions and are recorded as nonoperating revenues including state appropriations, federal Pell grants, gifts and investment income.

The preparation of 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 accompanying notes. Actual results could differ from those estimates. The most significant areas that require management estimates relate to self-insurance and benefits obligations.

<u>Reclassifications</u>: Certain prior year amounts have been reclassified to conform with current year presentations.

<u>Subsequent Event</u>: In September 2016, the University and Metropolitan Health Corporation signed a definitive, non-binding agreement to affiliate and consummate a member substitution where the University would become the parent organization. The signing of this agreement did not have a material impact on the University's financial statements.

Note 2--Cash and Investments

Summary: The University maintains centralized management for substantially all of its cash and investments.

Working capital of individual University units is invested in the University Investment Pool ("UIP"). Together with the University's short-term insurance and other benefits reserves, the UIP is invested in the Daily and Monthly Portfolios, which are principally invested in investment-grade money market securities, U.S. government and other fixed income securities and absolute return strategies.

The University collectively invests substantially all of the assets of its endowment funds along with a portion of its insurance and benefits reserves, charitable remainder trusts and gift annuity program in the Long Term Portfolio. The longer investment horizon of the Long Term Portfolio allows for an equity-oriented strategy to achieve higher expected returns over time, and permits the use of less liquid alternative investments, providing for equity diversification beyond the stock markets. The Long Term Portfolio includes investments in domestic and non-U.S. stocks and bonds, commingled funds and limited partnerships consisting of venture capital, private equity, real estate, natural resources and absolute return strategies.

The University also separately invests certain endowments and charitable remainder trusts, unexpended bond proceeds and other funds with investment restrictions outside of the Daily, Monthly and Long Term Portfolios.

Authorizations: The University's investment policies are governed and authorized by University Bylaws and the Board of Regents. The approved asset allocation policy for the Long Term Portfolio sets a general target of 80 percent equities and 20 percent fixed income securities, within a permitted range of 65 to 90 percent for equities and 10 to 35 percent for fixed income securities. Since diversification is a fundamental risk management strategy, the Long Term Portfolio is broadly diversified within these general categories.

The endowment spending rule provides for distributions from the University Endowment Fund to the University entities that benefit from the endowment fund. At June 30, 2016 and 2015, the annual distribution rate was 4.5 percent of the one-quarter lagged seven year moving average fair value of fund shares. To protect endowment principal in the event of a prolonged market downturn, distributions are limited to 5.3 percent of the current fair value of fund shares. Distributions are also made from the UIP to University entities based on the 90-day U.S. Treasury Bill rate. The University's costs to administer and grow the University Endowment Fund and UIP are funded by investment returns.

Note 2--Cash and Investments--Continued

Cash and Cash Equivalents: Cash and cash equivalents, which totaled $285,838,000 and $105,465,000 at June 30, 2016 and 2015, respectively, represent short-term money market investments in mutual funds, overnight collective funds managed by the University's custodian or short-term highly liquid investments registered as securities and held by the University or its agents in the University's name. Of its cash and cash equivalents, the University had actual cash balances in its bank accounts in excess of Federal Deposit Insurance Corporation limits in the amount of $9,687,000 and $9,136,000 at June 30, 2016 and 2015, respectively. The University does not require its deposits to be collateralized or insured.

Cash and cash equivalents include certain securities that are subject to the leveling requirements defined by GASB 72. Level 1 securities, which primarily consist of money market funds and U.S. government securities, totaled $63,433,000 and $37,424,000 at June 30, 2016 and 2015, respectively. Level 2 securities, which primarily consist of U.S. agencies, totaled $96,343,000 and $39,993,000 at June 30, 2016 and 2015, respectively.

Investments: At June 30, 2016 and 2015, the University's investments, which are held by the University or its agents in the University's name, are summarized as follows:

	2016	2015
	(in thousands)	
Cash equivalents, noncurrent	$ 161,500	$ 52,461
Equity securities	1,396,023	1,300,173
Fixed income securities	1,868,581	2,301,472
Commingled funds	2,597,267	2,903,066
Nonmarketable alternative investments	5,308,968	4,997,621
Other investments	10,746	17,212
	$ 11,343,085	$ 11,572,005

Note 2--Cash and Investments--Continued

GASB 72 establishes a hierarchy that prioritizes inputs to valuation techniques used to measure fair value. At June 30, 2016 and 2015, the fair value of the University's investments based on the inputs used to value them is summarized as follows:

	2016				
	Level 1	Level 2	Level 3 (in thousands)	NAV	Total Fair Value
Cash equivalents, noncurrent	$ 161,500				$ 161,500
Equity securities:					
Domestic	457,605		$ 18,868		476,473
Foreign	918,992		558		919,550
	1,376,597	-	19,426	-	1,396,023
Fixed income securities:					
U.S. Treasury	537,988				537,988
U.S. government agency		$ 287,098			287,098
Corporate and other		880,777	162,718		1,043,495
	537,988	1,167,875	162,718	-	1,868,581
Commingled funds:					
Absolute return				$ 1,578,437	1,578,437
Domestic equities	16,094			246,522	262,616
Global equities	9,222			692,613	701,835
U.S. fixed income	5,817			43,222	49,039
Other	5,340				5,340
	36,473	-	-	2,560,794	2,597,267
Nonmarketable alternative investments:					
Venture capital				1,306,581	1,306,581
Absolute return				1,092,694	1,092,694
Private equity			162,878	1,130,422	1,293,300
Real estate			8,590	907,602	916,192
Natural resources			168,897	531,304	700,201
	-	-	340,365	4,968,603	5,308,968
Other investments	213	549	9,984		10,746
	$ 2,112,771	$ 1,168,424	$ 532,493	$ 7,529,397	$ 11,343,085

Note 2--Cash and Investments--Continued

	2015				
	Level 1	Level 2	Level 3 (in thousands)	NAV	Total Fair Value
Cash equivalents, noncurrent	$ 52,461				$ 52,461
Equity securities:					
Domestic	436,536		$ 11,051		447,587
Foreign	852,570		16		852,586
	1,289,106	-	11,067	-	1,300,173
Fixed income securities:					
U.S. Treasury	844,161				844,161
U.S. government agency		$ 396,594			396,594
Corporate and other		900,894	159,823		1,060,717
	844,161	1,297,488	159,823	-	2,301,472
Commingled funds:					
Absolute return				$ 1,385,538	1,385,538
Domestic equities	15,387			314,652	330,039
Global equities	11,140			1,120,363	1,131,503
U.S. fixed income	6,424			43,633	50,057
Other	5,929				5,929
	38,880	-	-	2,864,186	2,903,066
Nonmarketable alternative investments:					
Venture capital	-	-		1,362,389	1,362,389
Absolute return				807,894	807,894
Private equity			89,252	1,208,261	1,297,513
Real estate			7,137	907,535	914,672
Natural resources			177,830	437,323	615,153
	-	-	274,219	4,723,402	4,997,621
Other investments	(1,725)	9,463	9,474		17,212
	$ 2,222,883	$ 1,306,951	$ 454,583	$ 7,587,588	$ 11,572,005

Investments categorized as Level 1 are valued using prices quoted in active markets for those securities. Equity securities categorized as Level 3 represent investments in start-up or venture companies. Fixed income securities categorized as Level 2 represent investments valued using a matrix pricing technique, which values debt securities based on their relationship to a benchmark and the relative spread to that benchmark. Fixed income securities categorized as Level 3 represent a note receivable associated with the sale of a portion of the University's nonmarketable alternative real estate investments. Certain assumptions about the appropriate yield curve and underlying credit rating of the issuer were made in determining the fair value of the note. Nonmarketable alternative investments categorized as Level 3 include direct investments and are primarily valued using models that rely on inputs which are unobservable in the market.

Note 2--Cash and Investments--Continued

The University's investment strategy incorporates certain financial instruments that involve, to varying degrees, elements of market risk and credit risk in excess of amounts recorded in the financial statements. Market risk is the potential for changes in the value of financial instruments due to market changes, including interest and foreign exchange rate movements and fluctuations embodied in forwards, futures and commodity or security prices. Market risk is directly impacted by the volatility and liquidity of the markets in which the underlying assets are traded. Credit risk is the possibility that a loss may occur due to the failure of a counterparty to perform according to the terms of the contract. The University's risk of loss in the event of a counterparty default is typically limited to the amounts recognized in the statement of net position and is not represented by the contract or notional amounts of the instruments.

Fixed income securities have inherent financial risks, including credit risk and interest rate risk. Credit risk for fixed income securities is the risk that the issuer will not fulfill its obligations. Nationally recognized statistical rating organizations (“NSROs”), such as Moody’s and Standard & Poor’s, assign credit ratings to security issues and issuers that indicate a measure of potential credit risk to investors. Fixed income securities considered investment grade are those rated at least Baa by Moody’s and BBB by Standard & Poor’s. To manage credit risk, the University specifies minimum average and minimum absolute quality NSRO ratings for securities held pursuant to its management agreements.

The University minimizes concentration of credit risk, the risk of a large loss attributed to the magnitude of the investment in a single issuer of fixed income securities, by diversifying its fixed income issues and issuers and holding U.S. Treasury securities which are considered to have minimal credit risk. The University also manages this risk at the account level by limiting each fixed income manager’s holding of any non-U.S. government issuer to 5 percent of the value of the investment account.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of fixed income securities. Effective duration, a commonly used measure of interest rate risk, incorporates a security’s yield, coupon, final maturity, call features and other imbedded options into one number expressed in years that indicates how price-sensitive a security or portfolio of securities is to changes in interest rates. The effective duration of a security or portfolio indicates the approximate percentage change in fair value expected for a one percent change in interest rates. The longer the duration, the more sensitive the security or portfolio is to changes in interest rates. The weighted average effective duration of the University’s fixed income securities was 5.9 years at June 30, 2016, compared to 3.4 years at June 30, 2015. The University manages the effective duration of its fixed income securities at the account level, where fixed income managers generally may not deviate from the duration of their respective benchmarks by more than 25 percent. The Monthly Portfolio held positions in bond futures at June 30, 2016 and 2015, which are used to adjust the duration of cash equivalents and the fixed income portion of the portfolios.

Note 2--Cash and Investments--Continued

The composition of fixed income securities at June 30, 2016 and 2015, along with credit quality and effective duration measures, is summarized as follows:

	2016					
	U.S. Government	Investment Grade	Non-Investment Grade (in thousands)	Not Rated	Total	Duration (in years)
U.S. Treasury	$ 308,171				$ 308,171	9.0
U.S. Treasury inflation protected	229,817				229,817	2.7
U.S. government agency	287,098				287,098	1.0
Mortgage backed		$ 18,875	$ 4,603	$ 531	24,009	1.8
Asset backed		50,113	864		50,977	2.3
Corporate and other		949,218	12,326	6,965	968,509	7.4
	$ 825,086	$ 1,018,206	$ 17,793	$ 7,496	$ 1,868,581	5.9

	2015					
	U.S. Government	Investment Grade	Non-Investment Grade (in thousands)	Not Rated	Total	Duration (in years)
U.S. Treasury	$ 617,218				$ 617,218	1.3
U.S. Treasury inflation protected	226,943				226,943	3.1
U.S. government agency	396,594				396,594	0.8
Mortgage backed		$ 42,578	$ 11,738	$ 7,738	62,054	1.6
Asset backed		31,509	1,553		33,062	3.5
Corporate and other		923,984	33,984	7,633	965,601	6.1
	$ 1,240,755	$ 998,071	$ 47,275	$ 15,371	$ 2,301,472	3.4

Of the University’s fixed income securities, 99 percent and 97 percent were rated investment grade or better at June 30, 2016 and 2015, and 51 percent and 59 percent of these securities consisted of either U.S. treasury and government agencies or non-U.S. government securities rated AAA/Aaa at June 30, 2016 and 2015, respectively. Corporate and other fixed income securities include a receivable associated with the sale of a portion of the University’s real estate nonmarketable alternative investments which totaled $160,305,000 and $157,832,000 at June 30, 2016 and 2015, respectively.

Commingled (pooled) funds include Securities and Exchange Commission regulated mutual funds and externally managed funds, limited partnerships and corporate structures which are generally unrated and unregulated. Certain commingled funds may use derivatives, short positions and leverage as part of their investment strategy. These investments are structured to limit the University's risk exposure to the amount of invested capital.

Note 2--Cash and Investments--Continued

Nonmarketable alternative investments consist of limited partnerships and similar vehicles involving an advance commitment of capital called by the general partner as needed and distributions of capital and return on invested capital as underlying strategies are concluded during the life of the partnership. There is not an active secondary market for these alternative investments, which are generally unrated and unregulated, and the liquidity of these investments is dependent on actions taken by the general partner. The University's limited partnerships are diversified in terms of manager selection, industry and geographic focus. At June 30, 2016 and 2015, no individual partnership investment represented 5 percent or more of total investments.

Absolute return strategies in the commingled funds and nonmarketable alternative investments classifications include long/short stock programs, merger arbitrage, intra-capital structure arbitrage and distressed debt investments. The goal of absolute return strategies is to provide, in aggregate, a return that is consistently positive and uncorrelated with the overall market.

The University's investments in commingled funds and nonmarketable alternative investments are contractual agreements that may limit the ability to initiate redemptions due to notice periods, lock-ups and gates. Additional information about current redemption terms and outstanding commitments at June 30, 2016 is summarized as follows (amounts in thousands):

	Fair Value	Remaining Life	Outstanding Commitments	Redemption Terms	Redemption Notice
Commingled funds	$ 2,597,267	N/A		Daily, monthly, quarterly, and annually, with varying notice periods	Lock-up provisions range from none to 3 years
Nonmarketable alternative investments	$ 5,308,968	1-12 years	$ 3,859,336	Ineligible for redemption	N/A

Commingled funds have liquidity (redemption) provisions, which enable the University to make full or partial withdrawals with notice, subject to restrictions on the timing and amount. Of the University's commingled funds at June 30, 2016 and 2015, approximately 83 percent and 88 percent are redeemable within one year, with 58 and 64 percent redeemable within 90 days under normal market conditions. The remaining amounts are redeemable beyond one year, with redemption of certain funds dependent on disposition of the underlying assets. The University's committed but unpaid obligation to nonmarketable alternative investments is further discussed in Note 13.

Note 2--Cash and Investments--Continued

The University participates in non-U.S. developed and emerging markets through commingled funds invested in non-U.S./global equities and absolute return strategies. Although substantially all of these funds are reported in U.S. dollars, price changes of the underlying securities in local markets as well as changes to the value of local currencies relative to the U.S. dollar are embedded in investment returns. In addition, a portion of the University's equity securities and nonmarketable alternative investments are denominated in foreign currencies, which must be settled in local (non-U.S.) currencies.

Foreign exchange risk is the risk that investments denominated in foreign currencies may lose value due to adverse fluctuations in the value of the U.S. dollar relative to foreign currencies. Forward foreign currency contracts are typically used to manage the risks related to fluctuations in currency exchange rates between the time of purchase or sale and the actual settlement of foreign securities. Various investment managers acting for the University use forward foreign exchange contracts in risk-based transactions to carry out their portfolio strategies and are subject to agreements that provide minimum diversification and maximum exposure limits by country and currency.

The value of the University's non-U.S. dollar holdings net of outstanding forward foreign exchange contracts totaled $940,947,000 or 8 percent of total investments at June 30, 2016, and $624,515,000 or 5 percent of total investments at June 30, 2015. Non-U.S. dollar exposures at June 30, 2016 and 2015 are summarized as follows:

	2016	**2015**
	(in thousands)	
Euros	$ 602,240	$ 574,210
British pounds sterling	142,091	(93,105)
Canadian dollar	113,689	8,771
Japanese yen	105,989	166,751
New Zealand dollar	(69,991)	(145,909)
Singapore dollar	(110,707)	(141,793)
Other	157,636	255,590
	$ 940,947	$ 624,515

Note 2--Cash and Investments--Continued

The Long Term Portfolio and the Monthly Portfolio participate in a short-term, fully collateralized, securities lending program administered by the University's master custodian. Together, the Portfolios had $95,505,000 and $91,157,000 in securities loans outstanding at June 30, 2016 and 2015, respectively. At loan inception, an approved borrower must deliver collateral of cash, securities or letters of credit to the University's lending agent equal to 102 percent of fair value for domestic securities and 105 percent for foreign securities. Collateral positions are monitored daily to ensure that borrowed securities are never less than 100 percent collateralized. At June 30, 2016, collateral of $99,200,000 (104 percent of securities on loan) includes invested cash of $63,292,000 and U.S. government securities of $35,908,000, while at June 30, 2015, collateral of $98,820,000 (108 percent of securities on loan) includes invested cash of $83,203,000 and U.S. government securities of $15,617,000.

Cash collateral held by the University's lending agent, along with the offsetting liability to return the collateral at loan termination, are recorded in the statement of net position. Neither the University nor its securities lending agent has the ability to pledge or sell securities received as collateral unless a borrower defaults. Securities loans may be terminated upon notice by either the University or the borrower.

Note 3--Accounts Receivable

The composition of accounts receivable at June 30, 2016 and 2015 is summarized as follows:

	2016	**2015**
	(in thousands)	
Patient care	$ 573,339	$ 584,311
Sponsored programs	133,196	113,594
State appropriations, educational and capital	86,795	65,701
Student accounts	28,935	29,580
Other	44,878	49,002
	867,143	842,188
Less allowance for uncollectible accounts receivable	251,174	261,897
	$ 615,969	$ 580,291

Note 4--Notes and Pledges Receivable

The composition of notes and pledges receivable at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in thousands)	
Notes:		
Federal student loan programs	$ 89,644	$ 89,839
University student loan funds	17,586	17,495
Other	851	673
	108,081	108,007
Less allowance for uncollectible notes	3,100	3,100
Total notes receivable, net	104,981	104,907
Gift pledges:		
Capital	179,712	184,184
Operations	122,932	121,938
	302,644	306,122
Less:		
Allowance for uncollectible pledges	11,411	5,581
Unamortized discount to present value	3,978	4,364
Total pledges receivable, net	287,255	296,177
Total notes and pledges receivable, net	392,236	401,084
Less current portion	73,958	79,445
	$ 318,278	$ 321,639

The principal repayment and interest rate terms of federal and university loans vary considerably. The allowance for uncollectible notes only applies to University funded notes and the University portion of federal student loans, as the University is not obligated to fund the federal portion of uncollected student loans. Federal loan programs are funded principally with federal advances to the University under the Perkins and various health professions loan programs.

Note 4--Notes and Pledges Receivable--Continued

Payments on pledges receivable at June 30, 2016 are expected to be received in the following years ended June 30 (in thousands):

2017	$ 60,537
2018	47,157
2019	35,048
2020	26,225
2021	27,063
2022 and after	106,614
	$ 302,644

As discussed in Note 1, permanent endowment pledges do not meet eligibility requirements, as defined by GASB, until the related gift is received. Accordingly, permanent endowment pledges totaling $168,434,000 and $154,133,000 at June 30, 2016 and 2015, respectively, are not recognized as assets in the accompanying financial statements. In addition, bequest intentions and other conditional promises are not recognized as assets until the specified conditions are met due to uncertainties with regard to their realizability and valuation.

Note 5--Capital Assets

Capital assets activity for the years ended June 30, 2016 and 2015 is summarized as follows:

	2016			
	Beginning Balance	Additions	Retirements	Ending Balance
	(in thousands)			
Land	$ 112,400	$ 1,366	$ 50	$ 113,716
Land improvements	123,003	3,166	1,117	125,052
Infrastructure	248,047	7,132		255,179
Buildings	7,486,312	490,954	20,777	7,956,489
Construction in progress	528,728	(76,581)		452,147
Property held for future use	24,502			24,502
Equipment	1,861,266	142,607	112,006	1,891,867
Library materials	567,461	26,306		593,767
	10,951,719	594,950	133,950	11,412,719
Less accumulated depreciation	5,329,333	501,631	126,821	5,704,143
	$ 5,622,386	$ 93,319	$ 7,129	$ 5,708,576

	2015			
	Beginning Balance	Additions	Retirements	Ending Balance
	(in thousands)			
Land	$ 112,011	$ 389		$ 112,400
Land improvements	116,677	8,564	$ 2,238	123,003
Infrastructure	241,528	6,519		248,047
Buildings	7,283,237	245,727	42,652	7,486,312
Construction in progress	270,963	257,765		528,728
Property held for future use	30,779	(6,277)		24,502
Equipment	1,879,237	122,262	140,233	1,861,266
Library materials	542,672	24,789		567,461
	10,477,104	659,738	185,123	10,951,719
Less accumulated depreciation	5,010,433	493,629	174,729	5,329,333
	$ 5,466,671	$ 166,109	$ 10,394	$ 5,622,386

The decrease in construction in progress of $76,581,000 in 2016 represents the amount of capital expenditures for new projects of $504,099,000 net of assets placed in service of $580,680,000. The increase in construction in progress of $257,765,000 in 2015 represents the amount of capital expenditures for new projects of $585,979,000 net of assets placed in service of $328,214,000.

Note 6--Long-term Debt

Long-term debt at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in thousands)	
Commercial Paper:		
Tax-exempt, variable rate (.467%)*	$ 155,085	$ 132,625
Taxable, variable rate (.549%)*	4,885	5,865
General Revenue Bonds:		
Series 2015, 4.00% to 5.00% through 2046	306,715	
unamortized premium	53,754	
Series 2014A,4.00% to 5.00% through 2044	79,560	81,310
Series 2014B, 0.597% to 3.516% through 2024	7,505	8,370
unamortized premium	7,433	7,914
Series 2013A, 2.75% to 5.00% through 2029	47,820	49,710
unamortized premium	2,133	2,395
Series 2012A, variable rate (.39%)* through 2036	50,000	50,000
Series 2012B, variable rate (.31%)* through 2042	65,000	65,000
Series 2012C, 5.00% through 2017	68,120	73,175
unamortized premium	2,590	5,373
Series 2012D-1, variable rate (.36%)* to fixed via swap through 2025	66,885	69,980
deferred amount on refunding	(12,335)	(14,409)
Series 2012D-2, variable rate (.41%)* to fixed via swap through 2026 and variable rate 2027 through 2030	71,110	75,085
deferred amount on refunding	(4,618)	(5,529)
Series 2012E**, variable rate (.84%)* through 2033	95,970	95,970
Series 2012F**, variable rate through 2016		100,970
Series 2010A, taxable-Build America Bonds, 4.926% to 5.593% through 2040	163,110	163,110
Series 2010C, 3.75% to 5.00% through 2027	138,970	149,970
unamortized premium	8,228	9,650
Series 2010D, taxable-Build America Bonds, 2.738% to 5.333% through 2041	181,190	189,095
Series 2009A, 3.00% to 5.00% through 2029	56,105	63,870
Series 2009B, variable rate (.43%)* through 2039	118,710	118,710
unamortized premium	5,040	5,430
Series 2009D, taxable-Build America Bonds, 5.155% to 6.172% through 2030	89,815	89,815
Series 2008A, variable rate (.37%)* through 2038	57,085	105,810
Series 2008B, variable rate (.39%)* to fixed via swap through 2026 and variable rate 2027 through 2028	83,590	89,725
Series 2005A, 5.00% through 2018	2,080	3,045
unamortized premium	50	98
Series 2002, variable rate (.44%)* to fixed via swap through 2018 and variable rate through 2016	14,785	76,285
	1,986,370	1,868,417
Less:		
Commercial paper and current portion of bonds payable	292,021	201,146
Long-term bonds payable subject to remarketing, net	217,637	336,374
	$ 1,476,712	$ 1,330,897

* Denotes variable rate at June 30, 2016
** Denotes variable rate bonds not subject to remarketing

Note 6--Long-term Debt--Continued

Certain variable rate bonds have remarketing features which allow bondholders to put debt back to the University. Accordingly, variable rate bonds payable is classified as current unless supported by liquidity agreements, such as lines of credit or standby bond purchase agreements, which can refinance the debt on a long-term basis. The classification of the University's variable rate bonds payable at June 30, 2016 and 2015 is summarized as follows:

	2016	**2015**
	(in thousands)	
Variable rate bonds payable subject to remarketing	$ 527,165	$ 650,595
Less:		
Current principal maturities	20,965	20,075
Long-term liquidity agreements:		
Unsecured line of credit	150,000	150,000
Standby bond purchase agreements	138,563	144,146
Long-term bonds payable subject to remarketing, net	$ 217,637	$ 336,374

The University's available line of credit and standby bond purchase agreements were entirely unused at June 30, 2016.

In connection with certain issues of variable rate debt, the University has entered into various floating-to-fixed interest rate swaps to convert all or a portion of the associated variable rate debt to synthetic fixed rates to protect against the potential of rising interest rates. The fair value, significant terms and other information about the University's interest rate swaps is discussed in Note 7.

Note 6--Long-term Debt--Continued

Long-term debt activity for the years ended June 30, 2016 and 2015 is summarized as follows:

2016	Beginning Balance	Additions	Reductions	Ending Balance
	(in thousands)			
Commercial paper	$ 138,490	$ 196,885	$ 175,405	$ 159,970
Bonds	1,729,927	361,364	264,891	1,826,400
	$ 1,868,417	$ 558,249	$ 440,296	$ 1,986,370

2015	Beginning Balance	Additions	Reductions	Ending Balance
	(in thousands)			
Commercial paper	$ 41,090	$ 136,915	$ 39,515	$ 138,490
Bonds	1,793,569		63,642	1,729,927
	$ 1,834,659	$ 136,915	$ 103,157	$ 1,868,417

The University maintains a combination of variable and fixed rate debt supported by general revenues, with effective interest rates that averaged 2.3 percent and 2.1 percent in 2016 and 2015, respectively, including federal subsidies for interest on taxable Build America Bonds. The University utilizes commercial paper to provide interim financing for its capital improvement program. The Board of Regents has authorized the issuance of up to $300,000,000 in commercial paper backed by a general revenue pledge. Outstanding commercial paper debt is converted to long-term debt financing, as appropriate, within the normal course of business.

During 2016, the University issued $306,715,000 of fixed rate General Revenue Bonds Series 2015 with a net original issue premium of $54,649,000. Total bond proceeds of $361,364,000 were utilized to convert $71,425,000 of commercial paper to long-term debt and refund $204,325,000 of existing bonds, as well as provide $84,685,000 for capital projects and $929,000 for debt issuance costs.

Note 6--Long-term Debt--Continued

Debt obligations are generally callable by the University and mature at various dates through fiscal 2046. Principal maturities, including amortization of deferred amounts on refunding and interest on debt obligations, based on scheduled bond maturities, for the next five years and in subsequent five-year periods are as follows:

	Principal	Interest* (in thousands)	Total
2017	$ 283,915	$ 58,676	$ 342,591
2018	56,675	53,813	110,488
2019	56,030	52,148	108,178
2020	57,615	50,291	107,906
2021	60,920	48,269	109,189
2022-2026	338,480	212,561	551,041
2027-2031	351,105	149,596	500,701
2032-2036	368,845	92,782	461,627
2037-2041	283,210	40,403	323,613
2042-2046	67,300	7,440	74,740
Total payments	1,924,095	$ 765,979	$ 2,690,074
Plus unamortized premiums, net	79,228		
Less deferred amount on refunding	16,953		
	$ 1,986,370		

* Interest on variable rate debt is estimated based on rates in effect at June 30, 2016; amounts do not reflect federal subsidies to be received for Build America Bonds interest.

If all variable rate bonds were put back to the University and existing unsecured lines of credit and standby bond purchase agreements were not extended upon their current expiration dates, the total principal payments due in 2017 would increase to $501,552,000, total principal payments due in 2018 would increase to $256,081,000, total principal payments due in 2019 would increase to $87,288,000 and total principal payments due in 2020 would increase to $65,764,000. Accordingly, principal payments due in subsequent years would be reduced to $45,920,000 in 2021; $228,755,000 in 2022 through 2026; $282,645,000 in 2027 through 2031; $230,005,000 in 2032 through 2036; $169,860,000 in 2037 through 2041; and $56,225,000 in 2042 through 2046. There would not be a material impact on annual interest payments due to the low variable rate of interest on these bonds.

Note 7--Derivative Instruments

Derivatives held by the University are recorded at fair value in the statement of net position in accordance with GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* ("GASB 53"). For hedging derivative instruments that are effective in significantly reducing an identified financial risk, as defined by GASB 53, the corresponding change in fair value is deferred and included in the statement of net position. For all other derivative instruments, changes in fair value are reported as net investment income (loss).

Derivative instruments held by the University at June 30, 2016 and 2015 are summarized as follows:

	2016		2015	
	Notional Amount	Fair Value	Notional Amount	Fair Value
	(in thousands)			
Investment Derivative Instruments:				
Investment portfolios:				
Futures	$ 252,104	$ 241	$ 571,891	$ (2,238)
Foreign currency forwards	1,714,843	11,139	2,173,950	(977)
Other	177,750	14,084	28,763	9,546
	$ 2,144,697	$ 25,464	$ 2,774,604	$ 6,331
Floating-to-fixed interest rate swap on debt	$ 14,785	$ (648)	$ 21,655	$ (971)
Effective Cash Flow Hedges:				
Floating-to-fixed interest rate swaps on debt	$ 180,420	$ (29,938)	$ 193,615	$ (27,377)

The University utilizes bond futures in its investment portfolios to adjust the duration of cash equivalents and fixed income securities, while foreign currency forward contracts are utilized to settle securities and transactions denominated in foreign currencies and manage foreign exchange risk. Other derivative instruments in the University's investment portfolios consist primarily of interest rate swaps, credit default swaps and total return swaps used to carry out investment and portfolio strategies.

In connection with certain issues of variable rate debt, the University has entered into various floating-to-fixed interest rate swaps to convert all or a portion of the associated variable rate debt to synthetic fixed rates to protect against the potential of rising interest rates. The fair value generally represents the estimated amount that the University would pay to terminate the swap agreements at the statement of net position date, taking into account current interest rates and creditworthiness of the underlying counterparty. The valuation inputs used to determine the fair value of these instruments are considered Level 2, as they rely on observable inputs other than quoted market prices. The notional amount represents the underlying reference of the instrument and does not represent the amount of the University's settlement obligations.

Note 7--Derivative Instruments--Continued

In accordance with GASB 53, an interest rate swap is considered an effective cash flow hedge if the swap payments received substantially offset the payments made on the associated debt. An interest rate swap that is not considered an effective cash flow hedge is deemed to be an investment derivative instrument and changes in fair value are recorded as net investment income (loss).

At June 30, 2016 and 2015, the fair value of floating-to-fixed interest rate swaps associated with the University's variable rate debt is a liability of $30,586,000 and $28,348,000, respectively, and is included in the statement of net position as part of noncurrent other liabilities. The deferred outflow of resources for the fair value of swaps deemed effective cash flow hedges totaled $12,985,000 and $7,439,000, at June 30, 2016 and 2015, respectively, and is included in the statement of net position as part of noncurrent other assets. Three bond issues were refunded in 2013 and the deferred outflow of resources related to the effective cash flow hedges associated with these bonds was reclassified to deferred amount on refunding and net against bonds payable. The deferred amount on refunding is being amortized into interest expense over the remaining term of the refunding bonds and totaled $16,953,000 and $19,938,000 at June 30, 2016 and 2015, respectively.

The change in fair value of derivative instruments, which includes realized gains and losses on positions closed, for the years ended June 30, 2016 and 2015 is summarized as follows:

	2016	**2015**
	(in thousands)	
Investment Derivative Instruments:		
Investment portfolios:		
Futures	$ (31,031)	$ 18,584
Foreign currency forwards	23,683	(3,836)
Other	1,992	(82)
	$ (5,356)	$ 14,666
Floating-to-fixed interest rate swap on debt	$ 323	$ 509
Effective Cash Flow Hedges:		
Floating-to-fixed interest rate swaps on debt	$ (2,561)	$ 1,835

Note 7--Derivative Instruments--Continued

The University's interest rate swaps, along with their associated variable rate debt and significant terms, are summarized below.

The floating-to-fixed interest rate swap associated with the Series 2008B General Revenue Bonds has a notional amount of $66,875,000 and $73,010,000 at June 30, 2016 and 2015, respectively, covering a portion of the principal outstanding and the notional amount decreases as principal on the underlying bonds is repaid. Effective April 1, 2008, the University makes payments based on a fixed rate of 3.105 percent and receives variable rate payments from the swap counterparty based on 68 percent of One-Month USD LIBOR, until the swap terminates in April 2026. The University has the option to terminate the swap upon five business days written notice and payment of the fair market compensation for the value of the swap. This swap is considered an effective hedge at June 30, 2016 and 2015 and has a fair value of ($9,064,000) and ($7,766,000), respectively.

The floating-to-fixed interest rate swap associated with the Series 2005B Hospital Revenue Bonds has a notional amount of $46,795,000 and $50,765,000 at June 30, 2016 and 2015, respectively. The Series 2005B Hospital Revenue Bonds were refunded on February 1, 2013, and the swap is now associated with the Series 2012D-2 General Revenue Bonds. Effective December 1, 2005, the University makes payments based on a fixed rate of 3.229 percent and receives variable rate payments from the swap counterparty based on 68 percent of the One-Month USD LIBOR, until the bonds mature in December 2025. The University has the option to terminate the swap upon five business days written notice and payment of the fair market compensation for the value of the swap. This swap is considered an effective hedge at June 30, 2016 and 2015 and has a fair value of ($5,874,000) and ($5,258,000), respectively.

The floating-to-fixed interest rate swap associated with the Series 2002 General Revenue Bonds has a notional amount of $14,785,000 and $21,655,000 at June 30, 2016 and 2015, respectively, covering a portion of the principal outstanding and the notional amount decreases as principal on the underlying bonds is repaid. Effective June 1, 2007, the University makes payments based on a fixed rate of 3.5375 percent and receives variable rate payments from the swap counterparty based on 68 percent of One-Month USD LIBOR, through April 1, 2009, and 63 percent of the Five-Year USD LIBOR Swap Rate for the balance of the term, through April 2018. The University has the option to terminate the swap upon five business days written notice and payment of the fair market compensation for the value of the swap. This swap is not considered an effective hedge at June 30, 2016 and 2015 and has a fair value of ($648,000) and ($971,000), respectively.

Note 7--Derivative Instruments--Continued

The floating-to-fixed interest rate swap associated with the Series 1998A-2 Hospital Revenue Refunding Bonds has a notional amount of $44,670,000 at both June 30, 2016 and 2015 tied to the outstanding balance of the bonds. The Series 1998A-2 Hospital Revenue Refunding Bonds were refunded on January 4, 2013, and the swap is now associated with the Series 2012D-1 General Revenue Bonds. Effective May 14, 1998, the University makes payments based on a fixed rate of 4.705 percent and receives variable rate payments from the swap counterparty based on the floating Securities Industry and Financial Markets Association ("SIFMA") Municipal Index through the final maturity dates of the underlying bonds in December 2024. The counterparty has the option of terminating the swaps if for any 180-day period the average variable rate is more than 7.0 percent. This swap is considered an effective hedge at June 30, 2016 and 2015 and has a fair value of ($12,230,000) and ($11,016,000), respectively.

The floating-to-fixed interest rate swap associated with the Series 1998A-1 Medical Service Plan Revenue Refunding Bonds has a notional amount of $22,080,000 and $25,170,000 at June 30, 2016 and 2015, respectively, tied to the outstanding balance of the bonds. The Series 1998A-1 Medical Service Plan Revenue Refunding Bonds were refunded on January 4, 2013, and the swap is now associated with the Series 2012D-1 General Revenue Bonds. Effective May 14, 1998, the University makes payments based on a fixed rate of 4.685 percent and receives variable rate payments based on the floating SIFMA Municipal Index through the final maturity dates of the underlying bonds in December 2024. The counterparty has the option of terminating the swaps if for any 180-day period the average variable rate is more than 7.0 percent. This swap is considered an effective hedge at June 30, 2016 and 2015 and has a fair value of ($2,770,000) and ($3,337,000), respectively.

Using rates in effect at June 30, 2016, the projected cash flows for the floating-to-fixed interest rate swaps deemed effective cash flow hedges, along with the debt service requirements of the associated variable rate debt, are summarized as follows:

	Variable Rate Bonds		Swap Payments, Net	Total Payments
	Principal	Interest		
	(in thousands)			
2017	$ 13,775	$ 834	$ 5,846	$ 20,455
2018	14,020	781	5,416	20,217
2019	13,770	727	4,970	19,467
2020	14,365	673	4,530	19,568
2021	15,000	615	4,051	19,666
2022-2026	109,725	1,865	8,798	120,388
2027-2030	40,930	251		41,181
	$ 221,585	$ 5,746	$ 33,611	$ 260,942

Note 7--Derivative Instruments--Continued

By using derivative financial instruments to hedge exposures to changes in interest rates, the University is exposed to termination risk and basis risk. There is termination risk with floating-to-fixed interest rate swaps because the University or swap counterparty may terminate a swap if the other party fails to perform under the terms of the contract or its credit rating falls below investment grade. Termination risk is the risk that the associated variable rate debt no longer carries a synthetic fixed rate and if at the time of termination a swap has a negative fair value, the University is liable to the counterparty for payment equal to the swap’s fair value. The University is also exposed to basis risk as some of the variable payments paid to the University by the counterparties are based on a percentage of LIBOR. Basis risk is the risk that changes in the relationship between SIFMA and LIBOR may impact the synthetic fixed rate of the variable rate debt. The University is not exposed to credit risk because the swaps have negative fair values.

The University is subject to collateral requirements with its counterparties on certain derivative instrument positions. To meet trading margin requirements for bond futures, the University had cash and U.S. government securities with a fair value of $17,003,000 and $12,220,000 at June 30, 2016 and 2015, respectively, on deposit with its futures broker as collateral.

Note 8--Self-Insurance

The University is self-insured for medical malpractice, workers' compensation, directors' and officers' liability, property damage, auto liability and general liability through Veritas Insurance Corporation. The University is also self-insured for various employee benefits through internally maintained funds.

Claims and expenses 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 and the future costs of handling claims. These liabilities are generally based on actuarial valuations and are reported at present value, discounted at a rate of 6 percent.

Changes in the total reported liability for insurance and benefits obligations for the years ended June 30, 2016 and 2015 are summarized as follows:

	2016	**2015**
	(in thousands)	
Balance, beginning of year	$ 192,905	$ 194,664
Claims incurred and changes in estimates	588,653	533,182
Claim payments	(578,355)	(534,941)
Balance, end of year	203,203	192,905
Less current portion	90,791	84,634
	$ 112,412	$ 108,271

Note 9--Postemployment Benefits

The University provides retiree health and welfare benefits, primarily medical, prescription drug, dental and life insurance coverage, to eligible retirees and their eligible dependents. Substantially all of the approximately 40,000 full-time regular University employees may become eligible for these benefits if they reach retirement age while working for the University. For employees retiring on or after January 1, 1987, contributions toward health and welfare benefits are shared between the University and the retiree and can vary based on date of hire, date of retirement, age and coverage elections.

The University also provides income replacement benefits, retirement savings contributions and health and life insurance benefits to substantially all regular University employees that are enrolled in a University sponsored long-term disability plan and qualify, based on disability status while working for the University, to receive basic or expanded long-term disability benefits. Contributions toward the expanded long-term disability plan are shared between the University and employees and vary based on years of service, annual base salary and coverage elections. Contributions toward the basic long-term disability plan are paid entirely by the University.

These postemployment benefits are provided through single-employer plans administered by the University. The Executive Vice Presidents of the University have the authority to establish and amend benefit provisions of the plans.

The University's annual postemployment benefits expense is actuarially determined in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* ("GASB 45"). Projections of benefits are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided and announced future changes at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point.

The University implemented GASB 45 in 2008 and elected to amortize its initial unfunded actuarial accrued liability over one year, the minimum period allowed by the Statement. The University also elected to amortize subsequent changes in actuarial assumptions, plan design and experience gains and losses over a ten-year closed period. Therefore, the liability for net postemployment benefits obligations recorded in the statement of net position may differ from the actuarial accrued liability due to the unamortized portion of these changes. At June 30, 2016, the recorded liability for net postemployment benefits obligations and the actuarial accrued liability totaled $1,840,583,000 and $1,844,785,000, respectively.

Note 9--Postemployment Benefits--Continued

Changes in the total reported liability for postemployment benefits obligations for the years ended June 30, 2016 and 2015 are summarized as follows:

	2016		
	Retiree Health and Welfare	Long-term Disability (in thousands)	Total
Balance, beginning of year	$ 1,588,838	$ 164,025	$ 1,752,863
Service cost	59,550	10,918	70,468
Amortization of assumption changes, plan changes and net actuarial (gains) losses	(28,671)	12,747	(15,924)
Interest cost	88,657	12,105	100,762
Payments of current premiums and claims	(47,893)	(19,693)	(67,586)
Balance, end of year	1,660,481	180,102	1,840,583
Less current portion	51,237	23,648	74,885
	$ 1,609,244	$ 156,454	$ 1,765,698

	2015		
	Retiree Health and Welfare	Long-term Disability (in thousands)	Total
Balance, beginning of year	$ 1,580,898	$ 150,556	$ 1,731,454
Service cost	40,987	9,300	50,287
Amortization of assumption changes, plan changes and net actuarial (gains) losses	(86,474)	10,741	(75,733)
Interest cost	96,119	11,864	107,983
Payments of current premiums and claims	(42,692)	(18,436)	(61,128)
Balance, end of year	1,588,838	164,025	1,752,863
Less current portion	45,479	19,693	65,172
	$ 1,543,359	$ 144,332	$ 1,687,691

Since a portion of retiree medical services will be provided by the University's Health System, the liability for postemployment benefits obligations is net of the related margin and fixed costs of providing those services which totaled $393,541,000 and $331,473,000 of actuarial accrued liability at June 30, 2016 and 2015, respectively. In accordance with GASB 45, the University's liability for postemployment benefits obligations at June 30, 2016 is not reduced by the anticipated Medicare Retiree Drug Subsidy for future periods of approximately $219,000,000 on an actuarial accrued liability basis.

Note 9--Postemployment Benefits--Continued

The annual required contribution represents a level of funding that an employer is projected to need in order to prefund its obligations for postemployment benefits over its employees' years of service and totals $190,334,000 and $112,864,000 at June 30, 2016 and 2015, respectively. The University has no obligation to make contributions in advance of when insurance premiums or claims are due for payment and currently pays for postemployment benefits on a pay-as-you-go basis. The University's postemployment benefits obligations at June 30, 2016, 2015 and 2014 as a percentage of covered payroll of $3,392,614,000, $3,228,997,000 and $3,083,357,000, was 54, 54 and 56 percent, respectively.

The University's recorded liability for postemployment benefits obligations was calculated using the projected unit credit method. Significant actuarial methods and assumptions used in the valuation for the years ended June 30, 2016 and 2015 are as follows:

	2016	
	Retiree Health and Welfare	Long-term Disability
Discount Rate	5.58%	7.38%
Immediate/Ultimate Administrative Trend Rate	0.0%/3.0%	0.0%/3.0%
Immediate/Ultimate Medical Trend Rate	5.5%-7.0%/4.5%	5.5%-7.0%/4.5%
Immediate/Ultimate Rx Trend Rate	10.5%/4.5%	10.5%/4.5%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2014 Generational	2005 SOA Life Waiver (Modified)

	2015	
	Retiree Health and Welfare	Long-term Disability
Discount Rate	6.08%	7.88%
Immediate/Ultimate Administrative Trend Rate	0.0%/3.0%	0.0%/3.0%
Immediate/Ultimate Medical Trend Rate	6.0%-7.0%/4.5%	6.0%-7.0%/4.5%
Immediate/Ultimate Rx Trend Rate	6.5%/4.5%	6.5%/4.5%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2000 Generational	2005 SOA Life Waiver (Modified)

The actuarial accrued liability is determined using current assumptions as of the valuation date, which may differ from those used to calculate the recorded liability.

Note 10--Retirement Plan

The University has a defined contribution retirement plan for all qualified employees through the Teachers Insurance and Annuity Association - College Retirement Equities Fund ("TIAA-CREF") and Fidelity Management Trust Company ("FMTC") mutual funds. All regular and supplemental instructional and primary staff are eligible to participate in the plan based upon age and service requirements. Participants maintain individual contracts with TIAA-CREF, or accounts with FMTC, and are fully vested.

For payroll covered under the plan, eligible employees generally contribute 5 percent of their pay and the University generally contributes 10 percent of employees' pay to the plan. Effective January 1, 2015, the plan was modified for certain employees of the University's health system who now generally contribute 4.5 percent of their pay, with the University contributing 9 percent of those employees' pay to the plan. The University contribution commences after an employee has completed one year of employment. Participants may elect to contribute additional amounts to the plans within specified limits that are not matched by University contributions. Contributions and covered payroll under the plan (excluding participants' additional contributions) for the three years ended June 30, 2016 are summarized as follows:

	2016	**2015** (in thousands)	**2014**
University contributions	$ 259,268	$ 251,614	$ 245,973
Employee contributions	$ 135,829	$ 131,545	$ 127,815
Payroll covered under plan	$ 3,392,614	$ 3,228,997	$ 3,083,357
Total payroll	$ 3,543,959	$ 3,385,973	$ 3,230,004

Note 11--Net Position

The composition of net position at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in thousands)	
Net investment in capital assets	$ 3,820,905	$ 3,782,130
Restricted:		
Nonexpendable:		
Permanent endowment corpus	1,815,575	1,673,996
Expendable:		
Net appreciation of permanent endowments	1,519,149	1,708,175
Funds functioning as endowment	1,942,388	2,061,089
Restricted for operations and other	657,482	602,343
Unrestricted	3,245,756	3,468,074
	$ 13,001,255	$ 13,295,807

Unrestricted net position, as defined by GASB, is not subject to externally imposed stipulations; however, it is subject to internal restrictions. For example, unrestricted net position may be designated for specific purposes by action of management or the Board of Regents. At June 30, 2016 and 2015, substantially all of the unrestricted net position has been designated for various academic programs, research initiatives and capital projects.

Note 12--Federal Direct Lending Program

The University distributed $292,106,000 and $303,638,000 for the years ending June 30, 2016 and 2015, respectively, for student loans through the U.S. Department of Education ("DoED") federal direct lending program. These distributions and related funding sources are not included as expenses and revenues in the accompanying financial statements. The statement of net position includes a receivable of $7,871,000 and a payable of $2,337,000 at June 30, 2016 and 2015, respectively, for DoED funding received subsequent or prior to distribution.

Note 13--Commitments and Contingencies

Authorized expenditures for construction and other projects unexpended as of June 30, 2016 were $1,072,287,000. Of these expenditures, the University expects that $1,009,952,000 will be funded by internal sources, gifts, grants and future borrowings, $25,910,000 by the State Building Authority and the remaining $36,425,000 will be funded using unexpended debt proceeds.

Under the terms of various limited partnership agreements approved by the Board of Regents or by University officers, the University is obligated to make periodic payments for advance commitments to venture capital, private equity, real estate, natural resources and absolute return strategies. As of June 30, 2016, the University had committed, but not paid, a total of $3,859,336,000 in funding for these alternative investments. Based on historical capital calls and discussions with those managing the limited partnerships, outstanding commitments for such investments are anticipated to be paid in the following years ended June 30 (in thousands):

2017	$ 1,352,188
2018	880,157
2019	667,404
2020	337,750
2021	231,254
2022 and beyond	390,583
	$ 3,859,336

These commitments are generally able to be called prior to an agreed commitment expiration date and therefore may occur earlier or later than estimated.

The University has entered into capital and operating leases for certain space and equipment, which expire at various dates through 2039. Outstanding commitments for these leases are expected to be paid in the following years ended June 30:

	Capital	Operating
	(in thousands)	
2017	$ 4,473	$ 30,670
2018	4,473	24,754
2019	4,473	20,709
2020	3,735	18,013
2021	3,045	16,673
2022-2026	14,913	46,649
2027-2031	15,322	368
2032-2036	16,089	150
2037-2039	9,936	
	76,459	$ 157,986
Less amount representing interest	38,386	
Present value of net minimum capital lease payments	$ 38,073	

Note 13--Commitments and Contingencies--Continued

Operating lease expenses totaled $32,929,000 and $35,821,000 in 2016 and 2015, respectively.

Substantial amounts are received and expended by the University under federal and state programs and are subject to audit by cognizant governmental agencies. This funding relates to research, student aid, patient care and other programs. The University believes that any liabilities arising from such audits will not have a material effect on its financial position.

The University is a party to various pending legal actions and other claims in the normal course of business, and is of the opinion that the outcome of these proceedings will not have a material adverse effect on its financial position.

Note 14--Operating Expenses by Function

Operating expenses by functional classification for the years ended June 30, 2016 and 2015 are summarized as follows:

	2016				
	Compensation and Benefits	Supplies and Services	Depreciation (in thousands)	Scholarships and Fellowships	Total
Instruction	$ 891,703	$ 139,307			$ 1,031,010
Research	494,907	259,907			754,814
Public service	117,025	65,120			182,145
Academic support	224,841	61,999			286,840
Student services	84,728	25,151			109,879
Institutional support	172,634	53,669			226,303
Operations and maintenance of plant	37,018	269,935			306,953
Auxiliary enterprises	2,604,559	1,016,431			3,620,990
Depreciation			$ 501,631		501,631
Scholarships and fellowships				$ 132,228	132,228
	$ 4,627,415	$ 1,891,519	$ 501,631	$ 132,228	$ 7,152,793

	2015				
	Compensation and Benefits	Supplies and Services	Depreciation (in thousands)	Scholarships and Fellowships	Total
Instruction	$ 844,505	$ 138,924			$ 983,429
Research	469,871	236,257			706,128
Public service	128,604	60,794			189,398
Academic support	207,878	58,304			266,182
Student services	79,609	24,447			104,056
Institutional support	161,661	49,570			211,231
Operations and maintenance of plant	35,588	242,159			277,747
Auxiliary enterprises	2,403,193	925,467			3,328,660
Depreciation			$ 493,629		493,629
Scholarships and fellowships				$ 132,758	132,758
	$ 4,330,909	$ 1,735,922	$ 493,629	$ 132,758	$ 6,693,218

UNIVERSITY OF MICHIGAN
HOSPITALS AND HEALTH CENTERS

FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2016 and 2015
with
REPORT OF INDEPENDENT AUDITORS

UNIVERSITY OF MICHIGAN
HOSPITALS AND HEALTH CENTERS

June 30, 2016 and 2015

Page(s)

pwc

Report of Independent Auditors

To The Regents of the University of Michigan:

We have audited the accompanying financial statements of the University of Michigan Hospitals and Health Centers ("HHC"), which consists of certain departments of the University of Michigan, as of and for the years ended June 30, 2016 and 2015 and the related notes to the financial statements, which consist of the statements of net position and the related statements of revenues, expenses and changes in net position and of cash flows.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on the financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to HHC's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of HHC's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

PricewaterhouseCoopers LLP, 500 Woodward Avenue, Detroit, MI 48226
T: (313) 394 6000, F: (313) 394 6555 www.pwc.com/us

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of HHC as of June 30, 2016 and 2015, and the changes in its financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

As discussed in Note 1, the financial statements of HHC present only the net position, revenues, expenses and changes in net position, and cash flows of that portion of the financial reporting entity of the University of Michigan that is attributable to the transactions of HHC. They do not purport to, and do not, present fairly the financial position of the University of Michigan at June 30, 2016 and 2015, and the changes in its financial position or its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis on pages 3 through 20 is required by accounting principles generally accepted in the United States of America to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

PricewaterhouseCoopers LLP

October 20, 2016

PricewaterhouseCoopers LLP, 500 Woodward Avenue, Detroit, MI 48226
T: (313) 394 6000, F: (313) 394 6555 www.pwc.com/us

Management's Discussion and Analysis (Unaudited)

Introduction

The following discussion and analysis provides an overview of the financial position of the University of Michigan Hospitals and Health Centers ("HHC") at June 30, 2016 and 2015 and its activities for the three fiscal years ended June 30, 2016. 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.

HHC is a part of the University of Michigan (the "University"), and is one of three University units that together comprise the University of Michigan Health System ("UMHS"). Along with HHC, UMHS includes the University of Michigan Medical School ("Medical School") and Michigan Health Corporation. UMHS maintains a tradition of excellence in teaching, advancement of medical science and patient care, consistently ranking among the best health care systems in the nation. The leadership and management of UMHS are provided by the University's Executive Vice President for Medical Affairs ("EVPMA").

UMHS entities have a tripartite mission focusing on clinical, research and medical and biomedical educational activities. As part of the clinical mission, HHC operates a 1,043-licensed bed acute care and psychiatric facility, several ambulatory care centers and various other health care programs in southeastern Michigan. HHC serves as the principal teaching facility of the Medical School. Substantially all physician services to HHC patients are provided by the University of Michigan Medical Group comprised of the Medical School faculty (formerly the Faculty Group Practice) in support of the educational missions. HHC also provides educational and clinical opportunities to students of the University's Schools of Nursing, Dentistry, Pharmacy and Public Health.

UMHS and HHC have been recognized by several external organizations. During 2016, this recognition included:

- Being named to Becker's Hospital Review's annual list of the "100 Great Hospitals in America."
- For the eighth consecutive time, UMHS earning an "A" from the nonprofit Leapfrog Group patient safety organization based on performance on a wide array of patient safety measures.
- Being named to the U.S. News & World Report Honor Roll of the best 20 hospitals in the nation, as well as Best Hospital in Michigan and Detroit Metro area and receiving top tier national rank in 12 adult specialties.
- C.S. Mott Children's Hospital being named one of the best children's hospitals in the country in pediatric specialty care and the only one in Michigan ranked in all 10 pediatric specialty areas evaluated, according to U.S. News & World Report.
- Being named to the U.S. News & World Report Most Connected Hospitals list by using digital technology and electronic connectedness to improve satisfaction and treatment for patients.
- Being named as one of the 50 greenest hospitals in America by Becker's Hospital Review based on the commitment to reduce waste and benefit the environment.
- The Medical School being ranked as one of the top medical schools in the country for research and primary care by U.S. News & World Report.
- Primary care physicians of the University of Michigan Medical Group scoring higher than nearly all peers on adult colorectal cancer screening, diabetes care and heart disease control in Consumer Reports' first-ever physician group ratings.
- UMHS being featured in Becker's Hospital Review's 150 Great Places to Work in Healthcare.

Financial Highlights

	2016	2015 (in millions)	2014
Operating Results			
Operating revenues	$ 3,015.9	$ 2,721.9	$ 2,494.6
Operating income	190.4	96.3	24.0
Increase (decrease) in net position	88.5	(40.0)	43.8

Operating revenues increased in 2016 due to continued growth in patient activity as well as increases in revenue per patient case. Operating expenses were higher in 2016 primarily due to costs associated with the growth in patient activity including increased expenses associated with pharmaceutical supplies. In 2016, operating income improved to $190.4 million compared to $96.3 million during 2015. Net position, which represents the residual interest in HHC's assets after liabilities are deducted, increased $88.5 million in 2016, driven principally by strong operating performance offset partially by equity transfers to the Medical School and unrealized market losses on investments.

Using the Financial Statements

HHC's financial report includes three financial statements: the Statement of Net Position; the Statement of Revenues, Expenses and Changes in Net Position; and the Statement of Cash Flows. These financial statements are prepared in accordance with Governmental Accounting Standards Board principles.

Statement of Net Position

The statement of net position presents the financial position of HHC at the end of the year and includes all assets and liabilities of HHC. The difference between total assets and total liabilities – net position – is one indicator of the current financial condition of HHC, while the change in net position is an indication of whether the overall financial condition improved or worsened during the year. A comparison of HHC's assets, liabilities and net position at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in millions)	
Current assets	$ 570.2	$ 408.1
Noncurrent assets:		
Investments	1,168.2	1,121.3
Capital assets, net	1,420.3	1,478.4
Other	21.7	12.8
Total assets	3,180.4	3,020.6
Current liabilities	281.8	189.5
Noncurrent liabilities:		
Long-term debt	882.7	912.7
Obligations for postemployment benefits	285.0	275.4
Other	39.5	40.1
Total liabilities	1,489.0	1,417.7
Net position	$ 1,691.4	$ 1,602.9

Current assets consist primarily of cash and cash equivalents and accounts receivable. Cash and cash equivalents on deposit with the University totaled $227.2 million and $74.0 million at June 30, 2016 and June 30, 2015, respectively. The net increase in cash and cash equivalents is primarily attributable to favorable changes in operating results and related cash collections.

Accounts receivable from patient care services is recorded at the estimated net realizable amount due from patients, third party payers, and others for services rendered. Accounts receivable from patient care services totaled $260.4 million at June 30, 2016, as compared to $257.7 million at June 30, 2015. The net increase in accounts receivable is consistent with increases in patient care revenues, due largely to increased activity, offset partially by an increase in cash collections.

Investments, consisting principally of long-term assets held in the University Endowment Fund, increased $46.9 million in 2016, due primarily to a transfer received from the Medical School of $95.3 million for investment in the clinical mission, offset partially by unrealized losses of $49.1 million.

Total cash, cash equivalents and investments, excluding restricted cash, amounted to $1.3 billion at June 30, 2016, which represents 188 days of operating expenses (excluding depreciation), as compared to $1.1 billion and 173 days at June 30, 2015.

Net capital assets, defined as gross capital assets less accumulated depreciation, decreased $58.1 million in 2016. Capital additions totaled $139.2 million in 2016 and $108.9 million in 2015, which included investments in clinical expansion as well as facility and information technology infrastructure improvements.

Current liabilities include accounts payable, accrued employee compensation, amounts due to other University units, third party settlements and reserves, and the current portion of obligations for postemployment benefits and outstanding debt. Third party settlements increased $63.4 million in 2016 primarily due to activity related to prior year estimates as well as the establishment of current year positions.

Total outstanding debt decreased $29.5 million to $912.8 million at June 30, 2016, with effective interest rates that averaged 3.7 percent. HHC borrowed no new debt in 2016 or 2015.

Obligations for postemployment benefits totaled $296.0 million and $284.5 million, of which $11.0 million and $9.1 million is current, at June 30, 2016 and 2015, respectively. The liability represents the actuarially determined value of certain medical and dental insurance, prescription drug coverage, group life insurance and long-term disability benefits to eligible retirees and their eligible dependents, discounted to present values.

Management's Discussion and Analysis (Unaudited)--Continued

Net position represents the residual interest in HHC’s assets after liabilities are deducted. The composition of HHC’s net position at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in millions)	
Net investment in capital assets	$ 507.5	$ 536.0
Restricted:		
Nonexpendable	4.9	4.7
Expendable	63.6	56.0
Unrestricted	1,115.4	1,006.2
	$ 1,691.4	$ 1,602.9

Net position invested in capital assets represents HHC’s 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 position includes the historical value (corpus) of gifts to HHC’s permanent endowment funds, as well as certain investment earnings stipulated by the donor to be reinvested permanently. Restricted expendable net position is subject to externally imposed stipulations governing their use.

Unrestricted net position is not subject to externally imposed donor or government stipulations.

Statement of Revenues, Expenses and Changes in Net Position

The statement of revenues, expenses and changes in net position presents HHC's results of operations. A comparison of revenues, expenses and other changes in net position for the three years ended June 30, 2016 is summarized as follows:

	2016	2015	2014
		(in millions)	
Operating revenues	$ 3,015.9	$ 2,721.9	$ 2,494.6
Operating expenses	2,825.5	2,625.6	2,470.6
Operating income	190.4	96.3	24.0
Total nonoperating and other (expenses) revenues, net	(13.1)	15.7	152.8
Net revenues before transfers	177.3	112.0	176.8
Transfers to other University units, net	(88.8)	(152.0)	(133.0)
Increase (decrease) in net position	$ 88.5	$ (40.0)	$ 43.8

Operating Revenues

Approximately 99 percent of operating revenues are from patient care. Patient care service revenue increased 11.1 percent in 2016 and 8.8 percent in 2015, driven primarily by growth in patient volume as well as an increase in revenue per patient case. A comparative summary of patient activity statistics for the three years ended June 30, 2016 is as follows:

				% Change	
	2016	2015	2014	2016	2015
Inpatient discharges	48,793	47,916	46,648	1.8%	2.7%
Patient days	300,018	293,569	289,657	2.2%	1.4%
Observation cases	18,199	16,282	16,875	11.8%	(3.5)%
Surgeries	54,342	52,246	51,583	4.0%	1.3%
Outpatient visits	2,424,473	2,234,769	2,097,086	8.5%	6.6%
Adjusted cases	121,505	113,328	106,354	7.2%	6.6%

Adjusted cases, which is an aggregate activity measurement combining inpatient discharges and outpatient/observation case activity, increased by 7.2 percent in 2016 and 6.6 percent in 2015.

The majority of patient care revenue is received under contractual arrangements with governmental payers (Medicare and Medicaid) and private insurers. HHC realized payment rate increases from the majority of private insurers and governmental payers as compared to 2015 and 2014. The following table shows the distribution of gross charge activity by primary payer source for 2016, 2015 and 2014.

	2016	2015	2014
Medicare	35.9%	35.6%	34.9%
Medicaid	16.7%	16.3%	15.1%
Blue Cross	32.6%	33.2%	34.0%
Other	14.8%	14.9%	16.0%

The state of Michigan’s Medicaid expansion prompted by the Patient Protection and Affordable Care Act contributed to increasing governmental payer mix by 0.7 percent and 1.9 percent, in 2016 and 2015, respectively.

Payments from these governmental payers are based on a combination of prospectively determined rates and retrospectively settled amounts. Many of the payment calculations require the use of estimates. Final settlement of the amount due to HHC or payable to the payers is subject to the laws and regulations governing the federal and state programs and post-payment audits, which may result in further adjustments by the payers. Management believes that reasonable provisions for anticipated adjustments have been made in the financial statements. Certain adjustments made by third parties in previously settled cost reports are being appealed. Recoveries are recognized in the financial statements as adjustments to prior year settlements at the time the appeals are resolved.

In 2016, HHC recognized $14.1 million in payments related to Michigan’s Medicaid expansion program for patient care services provided in 2016, as well as $12.6 million and $10.0 million for services provided in 2015 and 2014, respectively. These payments are recorded as net patient service revenue on the statement of revenues, expenses and changes in net position.

HHC regularly participates in initiatives with governmental and commercial payers to improve accessibility and quality of care for patients. HHC recognized $8.9 million and $7.8 million of other operating revenue to fund these initiatives in 2016 and 2015, respectively. Many of these initiatives are managed by the University of Michigan Medical Group. Accordingly, on behalf of HHC, $4.5 million and $3.9 million was paid to the Medical School in 2016 and 2015, respectively. The transfer of funds to the Medical School is represented as Medical School faculty and other services expense on the statement of revenues, expenses and changes in net position.

HHC regularly evaluates its agreements with commercial payers and makes amendments, as necessary. No such amendments were made in 2016 or 2015 that resulted in recognition of previously unrecognized non-recurring patient service revenue. In 2014, amendments to agreements with commercial payers resulted in the recognition of $11.8 million of non-recurring patient service revenue that had not been previously recognized.

HHC's average net facility revenue per patient encounter increased 4.0 percent and 2.0 percent in 2016 and 2015, respectively.

Under the Health Information Technology for Economic and Clinical Health Act, eligible health care professionals and hospitals can qualify for Medicare and Medicaid incentive payments when they adopt certified Electronic Health Record technology and use it to achieve specified objectives. These meaningful use objectives act as measurable benchmarks that providers must meet to qualify for the incentive payments. MiChart comprises multiple, integrated modules acquired from Epic Systems, which is already certified by the federal program. UMHS adopted a grant accounting model to recognize these meaningful use incentive payments, with gains being recognized when there is reasonable assurance that UMHS will comply with the meaningful use guidelines and that the funds will be received. A funds flow agreement between HHC and the Medical School was entered into in 2013 which states that all professional Medicare meaningful use incentive payments received will be split equally between HHC and the Medical School. In 2015, HHC was also deemed eligible to receive facility meaningful use payments from both Medicare and Medicaid. UMHS has met the reasonable assurance guidelines; therefore, HHC recognized $3.1 million as other operating revenue related to meaningful use incentive payments in 2016, $6.9 million in 2015 and $4.7 million in 2014.

Operating Expenses

A comparison of operating expenses for the three years ended June 30, 2016 is summarized as follows:

	2016	2015 (in millions)	2014
Compensation	$ 1,081.6	$ 1,013.6	$ 966.5
Benefits	347.8	308.9	301.8
Medical School faculty and other services	168.9	163.9	152.0
Expenses reimbursed by other UMHS units	(35.6)	(35.4)	(36.4)
Depreciation	196.0	202.7	209.5
UMHS Administrative Services	87.4	80.2	72.8
Supplies	704.0	621.4	523.3
Other operating expenses	275.4	270.3	281.1
Total operating expenses	$ 2,825.5	$ 2,625.6	$ 2,470.6

In total, operating expenses increased 7.6 percent and 6.3 percent in 2016 and 2015, respectively. Much of the growth in expenses is related to growth in patient activity, including increased expenses associated with pharmaceutical supplies.

Compensation increased 6.7 percent in 2016, as compared to a 4.9 percent increase in 2015, primarily due to growth in staffing levels, as well as wage rate increases. Staffing growth is primarily related to hiring due to increases in patient activity volumes.

Depreciation expense decreased 3.3 percent in 2016 as compared to a 3.2 percent decrease in 2015 primarily due to the planned stabilization of capital spending which began in 2014.

Supply expenses increased 13.3 percent in 2016, as compared to an 18.7 percent increase in 2015. Increases during 2016 were driven by a combination of higher activity levels, particularly in retail and specialty pharmacy prescriptions and infusion treatments, and higher costs of prescription drugs.

Other operating expenses increased 1.9 percent in 2016, as compared to a 3.8 percent decrease in 2015. During 2014, the third phase of MiChart impacting inpatient records went live. The activation costs associated with this implementation consisted largely of training and support provided by contracted groups. Contract services related to the MiChart project were $0.4 million in 2016, $3.9 million in 2015 and $22.3 million in 2014.

Nonoperating and Other Revenues (Expenses)

A comparison of nonoperating and other revenues (expenses) for the three years ended June 30, 2016 is summarized as follows:

	2016	2015 (in millions)	2014
Interest expense, net	$ (28.4)	$ (36.0)	$ (25.4)
Net investment (loss) income	(1.9)	46.4	167.9
Capital and permanent endowment gifts	1.6	0.2	5.2
Other nonoperating revenues, net	15.6	5.1	5.1
Total nonoperating and other (expenses) revenues, net	$ (13.1)	$ 15.7	$ 152.8

HHC participates in the University's debt stabilization program and is charged interest at a composite fixed rate based on available fixed rate debt instruments. Periodically, the University reviews payments made under the fixed rate schedules compared to actual interest payments made by the University to outside debt holders and may use any significant differences between actual amounts paid and collected to support future strategic projects. Excess payments under the debt stabilization program of $7.1 million and $10.7 million were reimbursed to HHC during 2016 and 2014, respectively. No amounts were reimbursed to HHC during 2015. These amounts are reflected as reductions to interest expense on the statement of revenues, expenses and changes in net position.

Substantially all HHC investments are held in University investment pools, which generate both income distributions and unrealized gains (losses). Income distributions consist primarily of payments from the University Endowment Fund based on the University’s endowment spending rule. Additionally, investments held in the University Endowment Fund are recorded at fair value based on the net asset value of the investment pool. Any unrealized change in the value of these investments is included as a component of net investment income.

Overall investment performance in 2016 was weaker compared to performance in 2015 and 2014. Net investment income for the three years ended June 30, 2016 is summarized as follows:

	2016	2015	2014
		(in millions)	
Income distributions and other investment income	$ 47.2	$ 43.9	$ 45.0
Net (decrease) increase in the fair value of investments	(49.1)	2.5	122.9
Net investment (loss) income including net realized and unrealized gains (losses)	$ (1.9)	$ 46.4	$ 167.9

In 2013, the gift agreement between HHC and the Samuel and Jean Frankel Foundation for the benefit of the Cardiovascular Center was amended. This amended agreement removed the eligibility requirements from the remaining $10.0 million of a previous gift, $2.5 million of which was received in each of 2016, 2015 and 2014, respectively, fulfilling the initial pledge. The center has also since been renamed the University of Michigan Samuel and Jean Frankel Cardiovascular Center. An additional $25.0 million gift from this same agreement was contingent upon achieving certain operational benchmarks. In 2016, those benchmarks were achieved and the present value of the non-endowed portion of the gift of $12.1 million was recorded as a pledge receivable in the statement of net position and correspondingly as nonoperating revenue in the statement of revenues, expenses and changes in net position. The remaining endowed portion of the gift will be recognized as cash is received.

In 2014, a gift agreement in the amount of $7.5 million was signed between HHC and Robert B. Aikens and Ann S. Aikens for the operating benefit of the Cardiovascular Center.

Transfers with Other University of Michigan Units

HHC makes equity transfers to the Medical School and other University units. These transfers are generally in support of the Medical School's academic and research missions. HHC reports these transfers as changes in net position, separately from the excess of revenues over expenses. HHC's practice is to record the equity transfer upon payment to the Medical School in accordance with the related agreement. Transfers with other University units for the three years ended June 30, 2016 are summarized as follows:

	2016	2015 (in millions)	2014
Transfers to:			
Medical School/University of Michigan Medical Group:			
Academic and non-patient care purposes	$ (181.8)	$ (151.0)	$ (130.7)
Other University units	(6.6)	(7.1)	(9.1)
	(188.4)	(158.1)	(139.8)
Transfers from:			
Medical School/University of Michigan Medical Group	96.9	2.2	1.8
Other units	2.7	3.9	5.0
	99.6	6.1	6.8
Transfers to other University units, net	$ (88.8)	$ (152.0)	$ (133.0)

Transfers to the Medical School/University of Michigan Medical Group increased $30.8 million in 2016 and $20.3 million in 2015 in order to further support the academic and research missions of the Medical School.

In 2016, a new internal arrangement between HHC and the Medical School was established to provide financial support for strategic investments and to increase faculty engagement and integration within the clinical mission. In total, the Medical School will transfer $225 million to HHC by 2017. Funds received will be invested in the University's Long Term Portfolio. As of June 30, 2016, the Medical School has transferred $95.3 million. In exchange for this investment, HHC will distribute transfers back to the Medical School equal to the University's endowment distribution rate applied to the investment on an annual basis, with additional distributions occurring based on various metrics related to the financial performance of the clinical mission. These transfers will commence in 2017.

Statement of Cash Flows

The statement of cash flows provides additional information about HHC'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, 2016 and 2015 is as follows:

	2016	2015
	(in millions)	
Cash received from operations	$ 3,120.2	$ 2,774.4
Cash expended for operations	(2,649.9)	(2,490.0)
Net cash provided by operating activities	470.3	284.4
Net cash (used in) provided by investing activities	(48.7)	39.8
Net cash used in capital and related financing activities	(183.1)	(170.7)
Net cash used in noncapital financing activities	(85.3)	(144.9)
Net increase in cash and cash equivalents	153.2	8.6
Cash and cash equivalents, beginning of year	74.0	65.4
Cash and cash equivalents, end of year	$ 227.2	$ 74.0

Cash received from operations primarily consists of patient care revenues. Net cash (used in) provided by investing activities primarily consists of realized investment income and withdrawals from the Long Term Portfolio in accordance with the distribution policy approved by the University Board of Regents. Net cash used in capital and related financing activities primarily consists of purchases of capital assets. Net cash used in noncapital financing activities primarily consists of transfers from HHC to the Medical School in support of the Medical School's academic and research missions.

Economic Factors That May Affect the Future

During 2016, HHC continued to execute its long-range plan for facility expansion and modernization. In May 2016, the four-bed Ambulatory Diagnostic and Treatment Unit opened in the Taubman Center and provides acute care for chronic conditions requiring an extended period of diagnostic and treatment time. In April 2016, the C.S. Mott Children's Hospital opened the 16,000 square foot Nyman Family Unit for Child and Adolescent Mental Health and Wellness. The 16-bed unit provides inpatient psychiatric care to patients through the age of 17. Finally, in July 2015, HHC opened a 22-bed medical short stay unit in University Hospital South to provide increased availability of care for patients who are anticipated to need medical observation or short-stay services.

In 2016, work continued on new projects, including the expansion of approximately 24,500 square feet within the surgical suite of University Hospital, which led to the opening of four new operating rooms in July 2016. Work also continued on the nearly 186,000 square foot Clinical Pathology project which will involve expansion into the North Campus Research Complex and renovation of existing space in University Hospital. Renovation also continued on the 7,000 square feet of existing space in the Livonia Center for Specialty Care and will allow improved patient access to Otolaryngology and Urology services. Finally in 2016, construction began on the West Ann Arbor Health Center relocation and expansion. This 75,000 square foot facility will provide primary and specialty care, infusion services, an ambulatory diagnostic and treatment center, walk-in clinic, clinical pathology and radiology services.

In 2016, capital spending for new projects was approved, including a new hybrid operating room in the University of Michigan Samuel and Jean Frankel Cardiovascular Center as well as a 297,000 square foot health center in the Brighton area to provide specialty services in both pediatric and adult health care, musculoskeletal health, ophthalmology, radiology and diagnostic imaging and pathology and comprehensive cancer service. These projects are expected to be available to patients between 2017 and 2019.

In May 2016, UMHS joined the Together Health Network as a referral provider for complex quaternary health care services. Also in 2016, UMHS continued to foster existing affiliations with area hospitals to enhance patient care, clinical research, physician recruitment and support services. UMHS continued to provide inpatient services at Chelsea Community Hospital and collaborate with St. Joseph Mercy Ann Arbor on a medical care unit specializing in geriatric care through the relationship with Trinity Health. UMHS also collaborated with affiliated partners Mid-Michigan Health and Sparrow Children's Center to continue to provide accessible, quality patient care.

UMHS continued participation in the Physicians Organization of Michigan Accountable Care Organization ("POM ACO") during 2016. POM ACO now includes over 5,200 providers from nine physician groups based in 17 counties which together are responsible for improving the care and health of more than 104,000 Michigan residents covered by Medicare. This participation allows UMHS to achieve its strategic goals for population health, position the state of Michigan as part of the future of health care and help keep care local to benefit patients.

The Medicare Shared Savings Program was established to facilitate coordination and cooperation among providers to improve the quality of care for Medicare beneficiaries and reduce unnecessary costs. In January 2016, POM ACO was selected as one of nearly 150 renewing Medicare Shared Savings Program Accountable Care Organizations ("ACOs"), bringing the total to 434 ACOs serving over 7.7 million beneficiaries. This program was established as part of the Affordable Care Act and places emphasis on improving the health of patients with a priority on prevention and wellness. In order to realize the savings associated with participation in this program, POM ACO will receive a portion of the Medicare savings generated from lowering the growth in health care costs as long as certain quality performance standards are met. While these clinical affiliation arrangements and population health management programs are not directly managed by HHC, they are designed to improve the quality of care for patients of UMHS as a whole.

Federal and state lawmakers continue to discuss further Medicare and Medicaid changes which may target graduate medical education-related payments, causing a potentially significant impact on teaching hospitals like HHC. HHC's private insurance and managed care contracts historically provide for annual increases in reimbursement rates that met or exceeded the rate of inflation; however there can be no assurance that such trends will continue. Given these challenges, management continues to explore and implement strategies to contain or reduce expense growth.

Effective April 2013 the Medicare program implemented a 2.0 percent fixed reduction in reimbursement rates referred to as Sequestration which was extended to 2023 by the Bipartisan Budget Act of 2013. Sequestration will effectively reduce HHC's reimbursement by approximately $10.3 million annually.

Several provisions of the Patient Protection and Affordable Care Act, including open enrollment in the Health Insurance Marketplace and Medicaid expansion, went into effect during 2014. Medicaid expansion in the state of Michigan through the Healthy Michigan Plan was signed into law in September 2013 and launched in April 2014. This plan currently covers approximately 600,000 Michigan residents. Medicaid expansion is 100 percent federally funded through federal fiscal year 2017. After this point the state of Michigan portion will increase, which is expected to result in a new hospital tax that will effectively reduce HHC's reimbursement by approximately $3.4 million to $6.8 million annually. Medicare Disproportionate Share Hospital ("DSH") payments are also being reduced by the Centers for Medicare & Medicaid Services to coincide with the reduction in the uninsured population. These incremental adjustments started in federal fiscal year 2014. Medicaid DSH payments are scheduled to have significant reductions starting in federal fiscal year 2017; however, the impact to HHC is anticipated to be negligible.

As a labor intensive organization, HHC's most significant operating expense is compensation and benefits, and management has resource strategies in place to attract and retain high quality staff. Many of these strategies are dependent on certain levels of patient volume being realized by the organization to offset the payroll costs that are associated with the additional resources. HHC continues to take steps to improve patient care while maintaining an effort to actively control its labor cost structure. A portion of HHC's labor force is unionized and negotiates agreements governing their employment. Changes in relations with unions and represented employees, including the negotiation of new agreements or work stoppages, could have a material effect on HHC's future financial results.

In response to the additional cost and revenue pressures previously mentioned, UMHS leadership has designed and implemented a multifaceted approach to creating sustainable improvements that enhance value and financial results in both clinical and administrative areas. In 2016, UMHS leadership also announced and implemented key changes to the organizational structure in order to better integrate across the tripartite mission. These key changes include combining the EVPMA and Medical School Dean roles and establishing a common leadership for the entire clinical mission in order to promote greater integration of the Medical School and clinical mission. These changes are intended to increase collaboration and innovation in how we provide care, thereby allowing HHC to manage challenges and maintain the long-term strategic direction of the organization.

Management's Discussion and Analysis (Unaudited)--Continued

Management believes that HHC is poised to succeed in an environment where quality, appropriateness and innovation are rewarded. As part of UMHS, HHC has a multi-year track record of a high degree of integration and alignment with the Medical School and University of Michigan Medical Group. This alignment and integration allows HHC to partner with highly talented physicians and in particular, physicians practicing in specialty areas, thereby providing a greater opportunity for future growth. This competitive advantage, coupled with a solid financial position and record of investment in clinical capacity and information technology, favorably positions HHC to deal with the emerging strategic initiatives listed above.

HHC participates in debt issuances originated by the University which maintains strong credit ratings with both Moody's (Aaa) and Standard & Poor's (AAA). These ratings allow HHC to secure capital funds as needed on extremely competitive terms to further enhance the patient experience. The continued stability of these credit ratings is important to the long-term strategic direction of HHC.

In September 2016, the University and Metropolitan Health Corporation ("Metro Health System") signed a definitive, non-binding agreement to affiliate and consummate a member substitution where the University would become the parent organization. The Metro Health System includes Metro Health Hospital, a 208-bed general acute-care osteopathic teaching hospital in Wyoming, Michigan and physician offices located throughout greater Grand Rapids. The new relationship will position both institutions to better and more efficiently serve patients and the community in a rapidly changing health care environment. The signing of this agreement did not have a material impact on HHC's financial statements.

Although there are many risks and uncertainties, HHC management believes it is well positioned to maintain its strong financial condition in the era of health care reform.

UNIVERSITY OF MICHIGAN
HOSPITALS AND HEALTH CENTERS

Statement of Net Position

	June 30, 2016	June 30, 2015
	(in thousands)	
Assets		
Current Assets:		
Cash and cash equivalents on deposit with the University	**$ 227,202**	$ 73,973
Accounts receivable, net	**260,396**	257,686
Receivable from other University units	**6,831**	7,635
Current portion of pledges receivable, net	**3,045**	4,427
Inventory and other current assets	**72,697**	64,384
Total Current Assets	**570,171**	408,105
Noncurrent Assets:		
Investments on deposit with the University	**1,168,165**	1,121,303
Pledges receivable, net	**18,973**	10,001
Other assets	**2,814**	2,815
Capital assets, net	**1,420,272**	1,478,355
Total Noncurrent Assets	**2,610,224**	2,612,474
Total Assets	**$ 3,180,395**	$ 3,020,579
Liabilities and Net Position		
Current Liabilities:		
Accrued compensation	**$ 84,860**	$ 72,880
Accounts payable and accrued expenses	**66,679**	54,772
Payable to other University units	**11,589**	8,886
Current portion of obligations for postemployment benefits	**10,958**	9,107
Current portion of long-term debt	**30,080**	29,589
Third party settlements and reserves	**77,631**	14,242
Total Current Liabilities	**281,797**	189,476
Noncurrent Liabilities:		
Long-term debt	**882,727**	912,738
Payable to other University units	**3,183**	3,503
Obligations for postemployment benefits	**284,996**	275,375
Other	**36,255**	36,540
Total Noncurrent Liabilities	**1,207,161**	1,228,156
Total Liabilities	**1,488,958**	1,417,632
Net Position:		
Net investment in capital assets	**507,465**	536,029
Restricted:		
Nonexpendable	**4,930**	4,662
Expendable	**63,643**	55,971
Unrestricted	**1,115,399**	1,006,285
Total Net Position	**1,691,437**	1,602,947
Total Liabilities and Net Position	**$ 3,180,395**	$ 3,020,579

The accompanying notes are an integral part of the financial statements.

UNIVERSITY OF MICHIGAN
HOSPITALS AND HEALTH CENTERS

Statement of Revenues, Expenses and Changes in Net Position

	Year Ended June 30, 2016 (in thousands)	2015
Operating Revenues		
Net patient service revenue (net of provision for bad debts of $67,794 in 2016 and $89,393 in 2015)	**$ 2,980,266**	$ 2,682,329
Other revenue	**35,674**	39,545
Total Operating Revenues	**3,015,940**	2,721,874
Operating Expenses		
Compensation and benefits	**1,393,758**	1,287,120
Medical School faculty and other services	**168,894**	163,876
Depreciation	**195,972**	202,737
UMHS Administrative Services	**87,413**	80,235
Supplies, services and other	**979,495**	891,619
Total Operating Expenses	**2,825,532**	2,625,587
Operating income	**190,408**	96,287
Nonoperating Revenues (Expenses)		
Interest expense, net	**(28,444)**	(35,997)
Net investment (loss) income	**(1,866)**	46,401
Private gifts for other than capital and permanent endowment purposes	**15,886**	5,383
Total Nonoperating (Expenses) Revenues, Net	**(14,424)**	15,787
Income before other revenues (expenses) and transfers	**175,984**	112,074
Other Revenues (Expenses)		
Capital and permanent endowment gifts	**1,576**	158
Loss on disposal of capital assets	**(281)**	(134)
Total Other Revenues, Net	**1,295**	24
Net revenues before transfers	**177,279**	112,098
Transfers to other University units, net	**(88,789)**	(152,013)
Increase (decrease) in net position	**88,490**	(39,915)
Net Position, Beginning of Year	**1,602,947**	1,642,862
Net Position, End of Year	**$ 1,691,437**	$ 1,602,947

The accompanying notes are an integral part of the financial statements.

UNIVERSITY OF MICHIGAN
HOSPITALS AND HEALTH CENTERS

Statement of Cash Flows

	Year Ended June 30, 2016	2015
	(in thousands)	
Cash Flows from Operating Activities		
Received from patient care services	**$ 3,040,941**	$ 2,693,643
Received from nonpatient sources	**37,362**	41,764
Expenses reimbursed by other University units	**41,908**	38,955
Payments to employees	**(1,401,291)**	(1,326,744)
Payments to suppliers	**(922,313)**	(853,239)
Payments to other University units	**(326,275)**	(309,978)
Net Cash Provided by Operating Activities	**470,332**	284,401
Cash Flows from Investing Activities		
Investment income	**47,255**	43,904
Increase in noncurrent investments and other assets	**(95,982)**	(4,118)
Net Cash (Used in) Provided by Investing Activities	**(48,727)**	39,786
Cash Flows from Capital and Related Financing Activities		
Purchases of capital assets, net	**(129,544)**	(110,134)
Interest payments, net	**(31,536)**	(39,244)
Principal payments on capital debt and capital lease obligations	**(28,378)**	(27,816)
Private gifts and other receipts	**3,583**	3,292
Payments from Medical School for capital projects	**2,792**	3,218
Net Cash Used in Capital and Related Financing Activities	**(183,083)**	(170,684)
Cash Flows from Noncapital Financing Activities		
Private gifts and other receipts	**6,288**	10,297
Transfers to other University units, net	**(91,581)**	(155,231)
Net Cash Used in Noncapital Financing Activities	**(85,293)**	(144,934)
Net increase in cash and cash equivalents	**153,229**	8,569
Cash and Cash Equivalents on Deposit with the University, Beginning of Year	**73,973**	65,404
Cash and Cash Equivalents on Deposit with the University, End of Year	**$ 227,202**	$ 73,973

The accompanying notes are an integral part of the financial statements.

UNIVERSITY OF MICHIGAN
HOSPITALS AND HEALTH CENTERS

Statement of Cash Flows--Continued

	Year Ended June 30, 2016	2015
	(in thousands)	
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 190,408	$ 96,287
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	195,972	202,737
Changes in assets and liabilities:		
Accounts receivable, net	(2,710)	34,370
Receivable from other University units	804	(1,586)
Inventory and other current assets	(8,313)	(12,694)
Accrued compensation	11,980	(4,065)
Accounts payable and accrued expenses	4,947	(5,238)
Due to other University units	2,383	1,999
Third-party settlements and reserves	63,389	(22,995)
Obligations for postemployment benefits	11,472	(4,414)
Net cash provided by operating activities	$ 470,332	$ 284,401

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

June 30, 2016 and 2015

Note 1--Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation: The Regents of the University of Michigan (the "University") have the ultimate responsibility for the University of Michigan Hospitals and Health Centers ("HHC") and, as part of the University, the financial statements of HHC are included in the consolidated financial statements of the University. HHC serves as the principal teaching facility for the University of Michigan Medical School ("Medical School"), and the majority of physician services to HHC patients are provided by Medical School faculty. As part of the University, HHC is exempt from income taxes under Internal Revenue Code Sections 501(c)(3) and 115.

HHC is an operating unit of the University of Michigan Health System ("UMHS"). Along with HHC, UMHS includes the Medical School and Michigan Health Corporation.

HHC and the Medical School maintain various agreements to address the financial design and integration of their patient care activities. The agreements provide for, among other things, the distribution of patient care revenue generated by HHC and the Medical School, responsibility for expenses related to patient care activities and equity transfers to the Medical School for academic and other non-patient care purposes. Revenue from hospital services and professional revenue from primary care and cancer center physicians is recorded by HHC, and all other professional revenue is recorded by the Medical School. Patient care expenses other than physician compensation are recorded by HHC, and the Medical School reimburses HHC for a portion of the costs associated with Medical School revenue. Physician compensation is recorded by the Medical School and HHC reimburses the Medical School for primary care and cancer center physicians. HHC also makes payments to the Medical School for faculty services provided to HHC related to faculty participation in the direction and supervision of clinical and graduate medical education programs.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board ("GASB"). HHC reports as a special purpose government entity engaged primarily in business type activities, as defined by GASB, on the accrual basis. Business type activities are those that are financed in whole or in part by fees charged to external parties for goods or services.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

Net position is categorized as:

- Net investment in capital assets: 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 position subject to externally imposed stipulations that it be maintained permanently. Such net position includes the corpus portion (historical value) of gifts to HHC's permanent endowment funds and certain investment earnings stipulated by the donor to be reinvested permanently.

  Expendable – Net position subject to externally imposed stipulations that can be fulfilled by actions of HHC pursuant to those stipulations or that expire by the passage of time. Such net position includes net appreciation of HHC's permanent endowment funds that have not been stipulated by the donor to be reinvested permanently.

- Unrestricted: Net position that is not subject to externally imposed stipulations. Unrestricted net position may be designated for specific purposes by action of management or the Board of Regents or may otherwise be limited by contractual agreements with outside parties. Substantially all unrestricted net position is designated for patient care programs and capital programs.

Adoption of New Accounting Standard: During 2016, the University adopted GASB Statement No. 72, *Fair Value Measurement and Application* ("GASB 72"). The adoption of this statement did not have a material impact on HHC's financial statements.

Summary of Significant Accounting Policies: For purposes of the statement of cash flows, HHC considers all highly liquid investments purchased with a maturity of three months or less, to be cash equivalents. Cash equivalents generally represent investments in the University Investment Pool ("UIP"), a short-term commingled pool managed by the University that can be readily liquidated to pay contractual liabilities.

Accounts receivable consists primarily of patient activity and is recorded net of allowances for uncollectible accounts receivable of $74,745,000 at June 30, 2016 and $76,661,000 at June 30, 2015. The allowance is based on management's judgment of potential uncollectible amounts, which includes such factors as historical experience and type of receivable.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

HHC receives pledges and bequests of financial support from corporations, foundations and individuals. Revenue is recognized when a pledge representing an unconditional promise to pay is received and all eligibility requirements, including time requirements, have been met. In the absence of such a promise, revenue is recognized when the gift is received. Permanent endowment pledges do not meet eligibility requirements, as defined by GASB, and are not recorded as assets until the related gift is received.

Unconditional promises to give that are expected to be collected in future years are recorded at the present value of the estimated future cash flows. The discounts on these amounts are computed using risk-free interest rates applicable to the years in which the promises are made, commensurate with expected future payments. An allowance for uncollectible pledges receivable is provided based on management's judgment of potential uncollectible amounts and includes such factors as prior collection history, type of gift and nature of fundraising.

Inventories consist primarily of medical and surgical, pharmaceutical and other supplies. Inventories are stated at the lower of cost or market, with the cost determined on the first-in, first-out basis.

Investments on deposit with the University primarily represent investments in the University Endowment Fund (“UEF”), a commingled pool which is invested entirely in the Long Term Portfolio, a diversified, equity-oriented investment pool managed by the University. The net asset value (“NAV”) of UEF shares is determined at the end of each calendar quarter based on the fair value of the pool. Participants may purchase or redeem UEF shares at NAV at each valuation date, subject to minimum holding and notice requirements.

Capital assets are recorded at cost or, if donated, at fair value at the date of donation. All capital assets other than land are depreciated using the straight-line method of depreciation using the following asset lives:

Buildings and leasehold improvements	3 to 50 years
Infrastructure and land improvements	3 to 25 years
Equipment and software	3 to 16 years

HHC accrues paid time off (“PTO”) leave for employees based upon length of service and employee classification. Accrued PTO leave benefits are paid at the employee’s regular hourly rate when used, paid as part of the annual PTO sellback program, or paid upon termination of employment, reduction in force, or start of a leave of absence. Pursuant to a change to the retirement plan policy effective January 2015, payout of unused PTO when leaving employment will not be eligible for retirement savings contributions for all employees except for union employees.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

HHC's policy for defining operating activities as reported on the statement of revenues, expenses, and changes in net position are those that generally result from exchange transactions such as payments or expenditures related to patient care services provided. Nearly all of HHC's revenues and expenses are the result of exchange transactions. Certain significant revenue streams are classified as nonoperating revenues, most notably investment income.

HHC has agreements with third-party payers that provide for payments to HHC at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payers and others for service rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payers. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in the future periods as final settlements are determined.

HHC provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. As HHC does not pursue collection of amounts once determined to qualify as charity care, they are not reported as revenues in the accompanying statement of revenues, expenses and changes in net position.

The preparation of 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 accompanying notes. Actual results could differ from those estimates. The most significant areas that require management estimates relate to valuation of accounts receivable, contractual arrangements with third party payers and reimbursement, as well as valuation of investments.

Subsequent Events: In September 2016, the University and Metropolitan Health Corporation signed a definitive, non-binding agreement to affiliate and consummate a member substitution where the University would become the parent organization. The signing of this agreement did not have a material impact on HHC's financial statements.

Reclassifications: Certain prior year amounts have been reclassified to conform with current year presentations.

Note 2--Cash and Investments

Cash and investments at June 30, 2016 and 2015 are summarized as follows:

	2016	2015
	(in thousands)	
Cash and cash equivalents – University Investment Pool	$ 227,202	$ 73,973
Investments:		
University Endowment Fund	1,168,090	1,121,230
Other investments	75	73
Total Investments	1,168,165	1,121,303
Total Cash, Cash Equivalents and Investments	$ 1,395,367	$ 1,195,276

In 2016, $95,267,000 of cash was transferred from the Medical School to HHC in accordance with a new internal agreement established to provide financial support for strategic investments and to increase faculty engagement and integration within the clinical mission. Funds received were invested in the University's Long Term Portfolio. See Note 7 for further discussion on this arrangement.

The University maintains centralized management for substantially all cash and investments of HHC. Cash reserves and relatively short duration assets are invested in the UIP, while longer term assets held in the UEF are invested in the University's Long Term Portfolio. The UIP is principally invested in investment-grade money market securities, U.S. government and other fixed income securities and absolute return strategies. The longer investment horizon of the Long Term Portfolio allows for an equity-oriented strategy to achieve higher expected returns over time, and permits the use of less liquid alternative investments, providing for equity diversification beyond the stock markets.

The UEF consists of both permanent endowments and funds functioning as endowment. Permanent endowments are those funds received from donors with the stipulation that the principal remain intact 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 HHC for long-term investment purposes, but are not limited by donor stipulations requiring HHC to preserve principal in perpetuity. Substantially all of the amounts invested by HHC in this pool are funds functioning as endowment.

Note 2--Cash and Investments--Continued

The University's investment policies are governed and authorized by University Bylaws and the Board of Regents. The approved asset allocation policy for the Long Term Portfolio, in which the UEF invests, sets a general target of 80 percent equities and 20 percent fixed income securities, within a permitted range of 65 to 90 percent for equities and 10 to 35 percent for fixed income securities. Since diversification is a fundamental risk management strategy, the Long Term Portfolio is broadly diversified within these general categories. At June 30, 2016 and 2015, the Long Term Portfolio consisted of cash and equivalents (1 percent and 1 percent), fixed income securities (9 percent and 14 percent), U.S. and non-U.S. equities (14 percent and 13 percent), commingled funds (25 percent and 26 percent) and nonmarketable alternative investments (51 percent and 46 percent).

Commingled (pooled) funds held in the Long Term Portfolio include Securities and Exchange Commission regulated mutual funds and externally managed funds, limited partnerships and corporate structures which are generally unrated and unregulated. Commingled funds have liquidity (redemption) provisions, which enable the University to make full or partial withdrawals with notice, subject to restrictions on the timing and amount. Commingled funds are primarily invested in non-U.S./global equities and absolute return strategies, but also include exposure to domestic fixed income and equity securities. Certain commingled funds may use derivatives, short positions and leverage as part of their investment strategy; however, these investments are structured to limit the University's risk exposure to the amount of invested capital.

Nonmarketable alternative investments held in the Long Term Portfolio consist of limited partnerships and similar vehicles involving an advance commitment of capital called by the general partner as needed and distributions of capital and return on invested capital as underlying strategies are concluded during the life of the partnership. These limited partnerships include venture capital, private equity, real estate, natural resources and absolute return strategies. There is not an active secondary market for these alternative investments, which are generally unrated and unregulated, and the liquidity of these investments is dependent on actions taken by the general partner.

Note 2--Cash and Investments--Continued

The Long Term Portfolio holds investments denominated in foreign currencies and forward foreign currency contracts used to manage the risk related to fluctuations in currency exchange rates between the time of purchase or sale and the actual settlement of foreign securities. Various investment managers acting for the University also use forward foreign exchange contracts in risk-based transactions to carry out their portfolio strategies. Foreign exchange risk is the risk that investments denominated in foreign currencies may lose value due to adverse fluctuations in the value of the U.S. dollar relative to foreign currencies. The Long Term Portfolio's non-U.S. dollar exposure amounted to 8 percent and 5 percent of the portfolio at June 30, 2016 and 2015, respectively.

The University's investment strategy incorporates certain financial instruments that involve, to varying degrees, elements of market risk and credit risk in excess of amounts recorded in the financial statements. Market risk is the potential for changes in the value of financial instruments due to market changes, including interest and foreign exchange rate movements and fluctuations embodied in forwards, futures and commodity or security prices. Market risk is directly impacted by the volatility and liquidity of the markets in which the underlying assets are traded. Credit risk is the possibility that a loss may occur due to the failure of a counterparty to perform according to the terms of the contract. The University's risk of loss in the event of a counterparty default is typically limited to the amounts recognized in the statement of net position and is not represented by the contract or notional amounts of the instruments.

HHC receives quarterly distributions from the UEF based on the University's endowment spending rule. At June 30, 2016 and 2015, the annual distribution rate was 4.5 percent of the one-quarter lagged seven year moving average fair value of fund shares. To protect endowment principal in the event of a prolonged market downturn, distributions are limited to 5.3 percent of the current fair value of fund shares. Monthly distributions are also made from the UIP to HHC based on the 90-day U.S. Treasury Bill rate. The University's costs to administer and grow the UEF and UIP are funded by investment returns.

Withdrawals may be made quarterly from the UEF, with thirty days' notice, based upon University policy, generally after a five year investment period. Withdrawals may be made from the UIP on a daily basis.

Note 2--Cash and Investments--Continued

GASB 72 defines fair value and establishes a framework for measuring fair value that includes a three tiered hierarchy of valuation inputs, placing a priority on those which are observable in the marketplace. Observable inputs reflect market data obtained from sources independent of the reporting entity and unobservable inputs reflect the entity's own assumptions about how market participants would value an asset or liability based on the best information available. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. The three levels of inputs, of which the first two are considered observable and the last unobservable, are as follows:

- Level 1 – Quoted prices for identical assets or liabilities in active markets that can be accessed at the measurement date

- Level 2 – Other significant observable inputs, either direct or indirect, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable; or market corroborated inputs

- Level 3 – Unobservable inputs

A significant portion of the underlying investments of the University's commingled pools include nonmarketable alternative investments and certain commingled funds described earlier in this note that are priced by managers using NAV. The proprietary valuation techniques and unobservable pricing assumptions used by these managers to estimate fair value may have a significant impact on the resulting fair value determination of these investments. However, HHC uses Level 2 inputs to measure the fair value of its investments in the University's commingled pools described in Note 1 and within this note, since shares may be purchased or sold subject to holding and notice requirements at the NAVs determined by the University.

Notes to Financial Statements--Continued

Note 3--Pledges Receivable

The composition of pledges receivable at June 30, 2016 and 2015 is summarized as follows:

	2016	**2015**
	(in thousands)	
Gift pledges outstanding:		
Capital	$ 10,150	$ 11,736
Operations	13,182	3,349
	23,332	15,085
Less:		
Allowance for uncollectible pledges	1,024	326
Unamortized discount to present value	290	331
Total pledges receivable, net	22,018	14,428
Less current portion	3,045	4,427
	$ 18,973	$ 10,001

Pledges receivable are recognized net of estimated uncollectable amounts when all applicable eligibility requirements are met.

In 2013, the gift agreement between HHC and the Samuel and Jean Frankel Foundation for the benefit of the Cardiovascular Center was amended. This amended agreement removed the eligibility requirements from the remaining $10,000,000 of a previous gift, $2,500,000 of which was received in each of 2016 and 2015, respectively, fulfilling the initial pledge. The center has also since been renamed the University of Michigan Samuel and Jean Frankel Cardiovascular Center. An additional $25,000,000 gift from this same agreement was contingent upon achieving certain operational benchmarks. In 2016, those benchmarks were achieved and the present value of the non-endowed portion of the gift of $12,116,000 was recorded as a pledge receivable in the statement of net position and correspondingly as nonoperating revenue in the statement of revenues, expenses and changes in net position. The remaining endowed portion of the gift will be recognized as cash is received.

Payments on pledges receivable at June 30, 2016 are expected to be received in the following years ended June 30 (in thousands):

2017	$ 3,517
2018	3,578
2019	2,938
2020	2,799
2021	2,750
2022 and after	7,750
	$ 23,332

Note 4--Capital Assets

Capital assets activity for the years ended June 30, 2016 and 2015 is summarized as follows:

2016

	Beginning Balance	Additions	Retirements	Ending Balance
	(in thousands)			
Land	$ 30,331	$ 92		$ 30,423
Land improvements	19,853	17	$ 1,117	18,753
Buildings	1,906,263	49,102	15,532	1,939,833
Equipment	1,081,038	73,221	90,826	1,063,433
Construction in progress	20,033	16,815		36,848
	3,057,518	139,247	107,475	3,089,290
Less accumulated depreciation	1,579,163	195,972	106,117	1,669,018
	$ 1,478,355	$ (56,725)	$ 1,358	$ 1,420,272

2015

	Beginning Balance	Additions	Retirements	Ending Balance
	(in thousands)			
Land	$ 29,943	$ 388		$ 30,331
Land improvements	21,940	151	$ 2,238	19,853
Buildings	1,905,802	24,532	24,071	1,906,263
Equipment	1,127,052	67,314	113,328	1,081,038
Construction in progress	3,473	16,560		20,033
	3,088,210	108,945	139,637	3,057,518
Less accumulated depreciation	1,515,745	202,737	139,319	1,579,163
	$ 1,572,465	$ (93,792)	$ 318	$ 1,478,355

The increase in construction in progress of $16,815,000 in 2016 represents the amount of capital expenditures for new projects of $139,247,000 net of capital assets placed in service of $122,432,000. Retirements of $107,475,000 in 2016 are primarily related to information technology and clinical equipment assets no longer in service. The increase in construction in progress of $16,560,000 in 2015 represents the amount of capital expenditures for new projects of $108,945,000 net of capital assets placed in service of $92,385,000. Retirements of $139,637,000 in 2015 are primarily related to assets no longer in service as a result of the implementation of the third stage of MiChart. No interest was capitalized in 2016 or 2015.

Note 4--Capital Assets--Continued

HHC's capital assets, net includes assets under capital leases of $35,048,000 and $35,722,000 at June 30, 2016 and 2015, respectively. These assets are principally comprised of the Northville Health Center building and equipment under capital lease.

Note 5--Long-term Debt

Long-term debt at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in thousands)	
Payable to the University:		
2013, 2.00% to 5.00% through 2016		$ 415
unamortized premium		78
2012, 4.71% through 2025	$ 44,760	44,760
2012, 3.23% to 3.25% through 2030	71,110	75,085
2012, 2.60% to 3.25% through 2033	84,780	84,780
2012, 3.65% through 2038	64,940	64,940
2012, 2.00% to 5.00% through 2042	56,710	56,710
2012, 2.00% to 5.00% through 2032	40,250	43,680
unamortized premium	1,562	3,240
2010, 0.68% to 5.00% through 2041	132,650	138,760
unamortized discount	(423)	(448)
2010, 3.20% to 3.64% through 2040	141,470	141,470
unamortized discount	(615)	(654)
2010, 2.00% to 5.00% through 2027	126,045	135,885
unamortized premium	7,044	8,180
2009, 2.00% to 5.00% through 2039	141,815	144,690
unamortized premium, net	709	756
	912,807	942,327
Less:		
Current portion of long-term debt	30,080	29,589
	$ 882,727	$ 912,738

Note 5--Long-term Debt--Continued

Long-term debt activity for the years ended June 30, 2016 and 2015 is summarized as follows:

	2016			
	Beginning Balance	Additions	Reductions	Ending Balance
	(in thousands)			
Payable to the University	$ 942,327	$ -	$ 29,520	$ 912,807

	2015			
	Beginning Balance	Additions	Reductions	Ending Balance
	(in thousands)			
Payable to the University	$ 971,750	$ -	$ 29,423	$ 942,327

HHC maintains fixed rate debt with an effective interest rate that averaged 3.7 percent and 3.6 percent in 2016 and 2015, respectively.

Principal maturities and interest on debt obligations, based on scheduled bond maturities, for the next five years and in subsequent five-year periods are as follows:

	Principal	Interest	Total
	(in thousands)		
2017	$ 27,345	$ 35,019	$ 62,364
2018	26,620	33,342	59,962
2019	28,530	32,353	60,883
2020	29,460	31,371	60,831
2021	33,470	30,411	63,881
2022-2026	197,935	129,641	327,576
2027-2031	204,510	89,855	294,365
2032-2036	206,385	54,092	260,477
2037-2041	145,110	15,696	160,806
2042	5,165	222	5,387
	904,530	$ 452,002	$ 1,356,532
Plus unamortized premiums, net	8,277		
	$ 912,807		

Note 5--Long-term Debt--Continued

HHC participates in the University's debt stabilization program and is charged interest at a composite fixed rate based on available fixed rate debt instruments. Fixed interest rates on debt obligations outstanding at June 30, 2016 and 2015 range from 0.68 percent to 5.0 percent. Periodically, the University reviews payments made under the fixed rate schedules compared to actual interest payments made by the University to outside debt holders and may use any significant differences between actual amounts paid and collected to support future strategic projects. Excess payments under the debt stabilization program of $7,081,000 were reimbursed to HHC during 2016 and no amount was reimbursed to HHC during 2015. These amounts are reflected as reductions to interest expense on the statement of revenues, expenses and changes in net position.

Note 6--Third Party Payment and Reimbursement

A substantial portion of HHC’s revenue is received under contractual arrangements with Medicare, Medicaid and Blue Cross and Blue Shield of Michigan. Payments from these third party payers are based on a combination of prospectively determined rates and retrospectively settled amounts. Many of the payment calculations require the use of estimates. Final settlement of the amount due to HHC or payable to the payers is subject to the laws and regulations governing the federal and state programs and post-payment audits, which may result in further adjustments by the payers. Management believes that reasonable provisions for anticipated adjustments have been made in the financial statements. Certain adjustments made by third parties in previously settled cost reports are being appealed. Recoveries are recognized in the financial statements as adjustments to prior year settlements at the time the appeals are resolved.

HHC also provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Since HHC does not pursue collection of amounts once determined to qualify as charity care, they are not reported as revenues in the accompanying statement of revenues, expenses and changes in net position. Charges foregone for services provided under HHC’s charity care policy for the years ended June 30, 2016 and 2015 were $48,203,000 and $20,557,000, respectively. Increases in charity care are the result of operational changes in the use of a new presumptive charity care screening process. This new process, implemented in mid-fiscal year 2015, follows industry best practices and allows for accounts that would have otherwise made their way to bad debt to be identified and qualified as charity care. Bad debt provisions for the years ended June 30, 2016 and 2015 were $67,794,000 and $89,393,000, respectively. This decrease is also directly attributable to the new charity care process. Both items, when considered in total, reflect a slight increase in charity and bad debt in 2016 of $6,047,000, which can be directly linked to increased volumes and charges.

Note 7--Transactions with Other University of Michigan Units

HHC has amounts receivable from and payable to other University units at June 30, 2016 and 2015 as follows:

	2016	2015
	(in thousands)	
Amounts receivable from other University units:		
Premium credit receivable from Veritas Insurance Corporation	$ 4,952	$ 6,829
Other	1,879	806
	$ 6,831	$ 7,635
Amounts payable to other University units:		
Medical School	$ 11,589	$ 8,886
Other	3,183	3,503
	14,772	12,389
Less current portion	11,589	8,886
Long-term payable to other University units	$ 3,183	$ 3,503

HHC is self-insured for medical malpractice, workers' compensation, directors' and officers' liability, property damage, auto liability and general liability through Veritas Insurance Corporation, a University-owned captive insurance company. HHC is also self-insured for various employee benefits through internally maintained funds. Premium reductions, in the form of premium credits, may be granted by the Veritas Board of Directors to recognize favorable claims experience compared to initial loss estimates. These premium credits are recorded as a reduction of supplies, services and other expenses on the statement of revenues, expenses and changes in net position. Premium credits of $4,952,000 and $6,829,000 were earned by HHC during 2016 and 2015, respectively.

In conjunction with the implementation of a new electronic medical records and patient billing system, services provided by UMHS began to be charged to patients using a single invoice methodology for both professional and facility related charges as opposed to a separate billing arrangement, which was used in prior periods. As part of this change in practice, all cash payments for both facility and professional services are received by HHC. While all cash received for facility services relates to HHC, a portion of the professional service payments received relate to services provided by the University of Michigan Medical Group. This cash is transferred to the Medical School when applied to a patient account. A liability of $11,589,000 and $8,886,000 was recorded for unapplied payments received by HHC that relate to services provided by the Medical School at June 30, 2016 and 2015, respectively.

Note 7--Transactions with Other University of Michigan Units--Continued

Other payable amounts consist principally of HHC's portion of expenses incurred by the UMHS Administrative Services organization.

HHC had various other transactions with University units for the years ended June 30, 2016 and 2015, which are summarized as follows:

	2016	2015
	(in thousands)	
Operating (expenses) revenues:		
Services provided by the Medical School:		
Clinical services	$ (168,894)	$ (163,514)
Billing services		(362)
Amounts received from the Medical School to reimburse HHC for expenses related to Medical School revenue and operating support, net	35,622	35,399
Services provided by other University units	(50,680)	(49,458)
Services provided to other University units	5,481	5,141
Premium insurance payments, net of credits provided by Veritas	(18,484)	(16,993)
Services provided by UMHS Administrative Services	(87,413)	(80,235)
Rent and other	(3,187)	(1,414)
Equity transfers to:		
Medical School:		
Academic and other non-patient care purposes, net	(84,917)	(148,776)
Other University units, net	(3,872)	(3,237)

HHC's operations are dependent on services received from the Medical School and the University's Executive Vice President for Medical Affairs ("EVPMA"), including the majority of the physician services that are provided to HHC patients. Accordingly, HHC recognizes expense for these services in operating expenses. HHC incurred $168,894,000 and $163,876,000 of expense for services provided by the Medical School in 2016 and 2015, respectively. HHC is also reimbursed for the salary cost of HHC employees that perform professional services related to the Medical School. These reimbursements are recorded as a reduction to compensation and benefits expense on the statement of revenues, expenses and changes in net position, and totaled $35,622,000 and $35,399,000 in 2016 and 2015, respectively.

Note 7--Transactions with Other University of Michigan Units--Continued

In the course of normal operations, HHC both provides and receives services from other University units. Services received include benefit administration, grounds maintenance, parking services, information technology, security services, payroll and human resources. HHC included $50,680,000 and $49,458,000 in operating expenses for these services during 2016 and 2015, respectively. Services provided by HHC include salaries for University Occupational Health Services and risk management administration. To compensate HHC for these services, various University units reimbursed HHC $5,481,000 and $5,141,000 during 2016 and 2015, respectively, which is included as a reduction to total operating expenses.

Operating expenses include HHC's share of the initial premiums charged by Veritas for liability, property and casualty insurance, including worker's compensation. The premiums are based on the present value, using a discount rate of 6 percent, of the ultimate losses as estimated by an independent actuary. Medical Professional Liability premiums and premium credits are allocated between HHC and the Medical School.

Certain HHC administrative functions are performed by a shared UMHS Administrative Services environment that combines similar functions from the Medical School and EVPMA office. Functions that are centralized include finance, legal, development and other services that can be provided from a single office to each part of the UMHS organization in a cost-effective manner. Costs incurred by the UMHS Administrative Services environment are allocated to each participating organization based upon efforts expended for each function. In 2016 and 2015, $87,413,000 and $80,235,000, respectively, of operating expense was allocated to HHC for the performance of these functions.

HHC conducts equity transfers to and receives equity transfers from other University units. These equity transfers are generally made in support of the research and academic missions and are made at the discretion of HHC leadership.

In 2016, a new internal arrangement between HHC and the Medical School was established to provide financial support for strategic investments and to increase faculty engagement and integration within the clinical mission. In total, the Medical School will transfer $225,000,000 to HHC by 2017. Funds received will be invested in the University's Long Term Portfolio. As of June 30, 2016, the Medical School has transferred $95,267,000. In exchange for this investment, HHC will distribute transfers back to the Medical School equal to the University's endowment distribution rate applied to the investment on an annual basis, with additional distributions occurring based on various metrics related to the financial performance of the clinical mission. These transfers will commence in 2017.

Note 8--Postemployment Benefits

HHC participates in the University's postemployment benefits plan which provides retiree health and welfare benefits; primarily medical, prescription drug, dental and life insurance coverage, to eligible retirees and their eligible dependents. Substantially all of HHC's regular employees may become eligible for these benefits if they reach retirement age while working for HHC. For employees retiring on or after January 1, 1987, contributions toward health and welfare benefits are shared between HHC and the retiree, and can vary based on date of hire, date of retirement, age and coverage elections.

The University also provides income replacement benefits, retirement savings contributions, and health and life insurance benefits to substantially all regular HHC employees who are enrolled in a University sponsored long-term disability plan and qualify, based on disability status while working for HHC, to receive basic or expanded long-term disability benefits. Contributions toward the expanded long-term disability plan are shared between HHC and employees and vary based on years of service, annual base salary and coverage elections. Contributions toward the basic long-term disability plan are paid entirely by HHC.

These postemployment benefits are provided through single-employer plans administered by the University. The Executive Vice Presidents of the University have the authority to establish and amend benefit provisions of these plans.

The University's annual postemployment benefits expense is actuarially determined in accordance with GASB Statement No. 45. Projections of benefits are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided and announced future changes at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point.

HHC's annual postemployment benefits expense and liability represents an allocation of HHC's relative share of the University's expense and liability, based on the method in which the retiree benefits are funded. The funding method is based upon a percentage of salary dollars of active employees who qualify for retiree benefits.

Note 8--Postemployment Benefits--Continued

Changes in the total reported liability for HHC's postemployment benefits obligations for the years ended June 30, 2016 and 2015 are summarized as follows:

	2016		
	Retiree Health and Welfare	Long-term Disability (in thousands)	Total
Balance, beginning of year	$ 283,229	$ 1,253	$ 284,482
Net benefits expense	11,361	111	11,472
Balance, end of year	294,590	1,364	295,954
Less current portion	10,751	207	10,958
	$ 283,839	$ 1,157	$ 284,996

	2015		
	Retiree Health and Welfare	Long-term Disability (in thousands)	Total
Balance, beginning of year	$ 288,151	$ 745	$ 288,896
Net benefits (income) expense	(4,922)	508	(4,414)
Balance, end of year	283,229	1,253	284,482
Less current portion	8,932	175	9,107
	$ 274,297	$ 1,078	$ 275,375

Since a portion of retiree medical services will be provided by HHC, the liability for postemployment benefit obligations is net of the related margin and fixed costs of providing those services which totaled $314,833,000 and $265,178,000 of actuarial accrued liability at June 30, 2016 and 2015, respectively. The marginal cost reduction adjusts HHC's liability for postemployment benefits obligations to reflect the true marginal cost of care for those retirees who utilize HHC.

HHC has no obligation to make contributions in advance of when insurance premiums or claims are due for payment and currently pays for postemployment benefits on a pay-as-you-go basis. HHC's obligations for postemployment benefits at June 30, 2016 and 2015 as a percentage of covered payroll of $1,056,842,000 and $993,290,000, was 28 and 29 percent, respectively.

Note 8--Postemployment Benefits--Continued

The University's postemployment benefits liability was calculated using the projected unit credit method. Significant actuarial methods and assumptions used in the valuation for the years ended June 30, 2016 and 2015 are as follows:

	2016	
	Retiree Health and Welfare	Long-term Disability
Discount Rate	5.58%	7.38%
Immediate/Ultimate Administrative Trend Rate	0.0%/3.0%	0.0%/3.0%
Immediate/Ultimate Medical Trend Rate	5.5%-7.0%/4.5%	5.5%-7.0%/4.5%
Immediate Ultimate Rx Trend Rate	10.5%/4.5%	10.5%/4.5%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2014 Generational	2005 SOA Life Waiver (Modified)

	2015	
	Retiree Health and Welfare	Long-term Disability
Discount Rate	6.08%	7.88%
Immediate/Ultimate Administrative Trend Rate	0.0%/3.0%	0.0%/3.0%
Immediate/Ultimate Medical Trend Rate	6.0%-7.0%/4.5%	6.0%-7.0%/4.5%
Immediate Ultimate Rx Trend Rate	6.5%/4.5%	6.5%/4.5%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2000 Generational	2005 SOA Life Waiver (Modified)

Note 9--Retirement Plan

HHC participates in the University's retirement plan, a defined contribution retirement plan through the Teachers Insurance and Annuity Association - College Retirement Equities Fund ("TIAA-CREF") and Fidelity Management Trust Company ("FMTC") mutual funds. All staff are eligible to participate in the plan based upon age and service requirements. Participants maintain individual contracts with TIAA-CREF, or accounts with FMTC, and are fully vested.

Pursuant to a change to the retirement plan policy effective January 2015, eligible employees may contribute up to 4.5 percent of their pay and HHC will contribute an amount equal to 9 percent of each employee's pay to the plan. Prior to this change, eligible employees contributed up to 5 percent of their pay and HHC generally contributed an amount equal to 10 percent of each employee's pay to the plan.

Also, effective January 2015, additional types of employee pay including administrative differentials, added-duties differentials, faculty honors, overtime, and the payout of unused vacation or PTO when leaving employment will not be eligible for retirement savings contributions for all employees except for union employees.

HHC's contribution commences after an employee has completed one year of employment. Participants may elect to contribute additional amounts to the plan within specified limits that are not matched by HHC contributions. Contributions and covered payroll under the plan (excluding additional participant contributions) for the three years ended June 30, 2016 are summarized as follows:

	2016	2015 (in thousands)	2014
HHC contributions	$ 79,354	$ 77,526	$ 75,424
Employee contributions	$ 41,573	$ 40,531	$ 39,193
Payroll covered under plan	$ 1,056,842	$ 993,290	$ 936,692
Total payroll	$ 1,082,337	$ 1,014,995	$ 967,726

Note 10--Commitments and Contingencies

HHC has entered into capital and operating leases for certain buildings and equipment, which expire at various dates through 2039. Outstanding commitments for these leases are expected to be paid in the following years ended June 30:

	Capital	Operating
	(in thousands)	
2017	$ 4,473	$ 21,376
2018	4,473	17,474
2019	4,473	15,474
2020	3,735	13,701
2021	3,045	13,217
2022-2026	14,913	41,963
2027-2031	15,322	320
2032-2036	16,089	150
2037-2039	9,936	
	76,459	$ 123,675
Less amount representing interest	38,386	
Present value of net minimum capital lease payments	$ 38,073	

Operating lease expenses, which include leases with other University units, totaled $33,206,000 and $32,831,000, in 2016 and 2015, respectively.

Capital lease obligations consist primarily of a 25-year lease involving the 100,000 gross square foot building, 10 acres of land and site improvements that now house the Northville Health Center facility.

HHC is a party to various pending legal actions and other claims in the normal course of business, and is of the opinion that the outcome of these proceedings will not have a material adverse effect on its financial position.

FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2016 and 2015
with
REPORT OF INDEPENDENT AUDITORS

INTERCOLLEGIATE ATHLETICS
OF THE UNIVERSITY OF MICHIGAN

June 30, 2016 and 2015

Page(s)

Report of Independent Auditors

To The Regents of the University of Michigan:

We have audited the accompanying financial statements of Intercollegiate Athletics of the University of Michigan ("ICA"), which consists of certain departments of the University of Michigan, as of and for the years ended June 30, 2016 and 2015 and the related notes to the financial statements, which consist of the statements of net position and the related statements of revenues, expenses and changes in net position and of cash flows.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on the financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to ICA's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the ICA's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

PricewaterhouseCoopers LLP, 500 Woodward Avenue, Detroit, MI 48226
T: (313) 394 6000, F: (313) 394 6555 www.pwc.com/us

pwc

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ICA at June 30, 2016 and 2015, and the changes in its financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

As discussed in Note 1, the financial statements of ICA present only the net position, revenues, expenses and changes in net position, and cash flows of that portion of the financial reporting entity of the University of Michigan that is attributable to the transactions of ICA. They do not purport to, and do not, present fairly the financial position of the University of Michigan at June 30, 2016 and 2015, and the changes in its financial position or its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis on pages 3 through 10 is required by accounting principles generally accepted in the United States of America to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

PricewaterhouseCoopers LLP

October 20, 2016

PricewaterhouseCoopers LLP, 500 Woodward Avenue, Detroit, MI 48226
T: (313) 394 6000, F: (313) 394 6555 www.pwc.com/us

Management's Discussion and Analysis (Unaudited)

Introduction

The following discussion and analysis provides an overview of the financial position of Intercollegiate Athletics of the University of Michigan ("ICA") at June 30, 2016 and 2015 and its activities for the three fiscal years ended June 30, 2016. 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.

ICA operates under the control of the Regents of the University of Michigan (the "University") to administer the intercollegiate athletic programs of the University. As part of the University, the assets, liabilities, revenues, expenses and changes in net position of ICA are included in the consolidated financial statements of the University. All organizations controlled by ICA, consisting of its various departments, are included in the financial statements. Organizations not controlled by ICA, such as certain booster and alumni organizations, are not included in the financial statements.

Using the Financial Statements

ICA's financial report includes three financial statements: the Statement of Net Position; the Statement of Revenues, Expenses and Changes in Net Position; and the Statement of Cash Flows. These financial statements are prepared in accordance with Governmental Accounting Standards Board ("GASB") principles.

Financial Highlights

ICA's financial position remains strong, with assets of $832.3 million and liabilities of $337.6 million at June 30, 2016, as compared to assets of $772.5 million and liabilities of $285.6 million at June 30, 2015. Net position, which represents the residual interest in ICA's assets after liabilities are deducted, grew by $7.8 million in 2016 and totaled $494.7 million at June 30, 2016 as compared to $486.9 million at June 30, 2015. ICA's operating results for the three years ended June 30, 2016 are summarized as follows:

	2016	**2015** (in millions)	**2014**
Operating Results			
Operating revenues	$ 114.9	$ 108.5	$ 114.4
Nonoperating and other revenues, net	$ 52.8	$ 44.7	$ 151.2
Operating expenses	$ 158.8	$ 151.5	$ 144.9
Increase in net position	$ 7.8	$ 1.0	$ 119.4

ICA's operating revenues increased $6.4 million in 2016 due primarily to increases in spectator admissions and conference distributions. ICA's operating revenues decreased $5.9 million in 2015 due primarily to decreases in spectator admissions and facilities revenues.

Significant recurring sources of revenue for ICA, including gifts and investment income, are included in nonoperating revenues, as required by GASB. Net nonoperating and other revenues increased $8.1 million in 2016 due primarily to an increase in capital gifts. Net nonoperating and other revenues decreased $106.5 million in 2015 due primarily to a decrease in capital gifts.

ICA's operating expenses increased $7.3 million in 2016 primarily due to increases in team travel expense and student financial aid. ICA's operating expenses increased $6.6 million in 2015 primarily due to the cost of employee severance, the investment in new football staff and an increase in student financial aid.

Statement of Net Position

The statement of net position presents the financial position of ICA at the end of the fiscal year, and includes all assets and liabilities of ICA. The difference between total assets and total liabilities – net position – is one indicator of the current financial condition of ICA, while the change in net position is an indication of whether the overall financial condition has improved or worsened during the year. A comparison of ICA assets, liabilities and net position at June 30, 2016 and 2015 is summarized as follows:

	2016	**2015**
	(in thousands)	
Net Current Assets (Liabilities):		
Cash equivalents	$ 137,043	$ 112,641
Receivables and other assets, net	22,574	17,595
Advance sale of game tickets	(43,819)	(38,064)
Current portion of notes payable	(5,730)	(5,485)
Other current liabilities	(21,962)	(15,236)
Total Net Current Assets	88,106	71,451
Net Noncurrent Assets (Liabilities):		
Unexpended debt proceeds	18,222	
Investments	92,111	89,532
Pledges receivable, net	90,133	87,593
Capital assets, net	469,508	463,941
Other noncurrent assets	2,750	1,250
Obligations for postemployment benefits	(17,913)	(17,052)
Notes payable	(235,249)	(207,475)
Other noncurrent liabilities	(12,911)	(2,327)
Total Net Noncurrent Assets	406,651	415,462
Net Position	$ 494,757	$ 486,913

Management's Discussion and Analysis (Unaudited)--Continued

ICA continues to make investments in its physical plant, financed by debt, capital gifts and reserves. In 2016, ICA completed the Athletic Department Operations Center in addition to commencing the Stephen M. Ross Athletics South Competition and Performance project and the Richard L. Postma Family Clubhouse project. In 2015, ICA completed the new field hockey team center and renovations to the Phyllis Ocker Field Hockey Field and commenced construction of the Athletic Department Operations Center.

Outstanding debt as of June 30, 2016 and 2015 totaled $241.0 million and $213.0 million, respectively. Over the past several years, debt has provided funding for the Athletics South Competition and Performance project, renovation of Michigan Stadium, the construction of the Al Glick Field House, the Crisler Center renovation and expansion projects, the William Davidson Player Development Center and other various projects.

In 2016, other noncurrent liabilities increased $10.6 million primarily due to an upfront base compensation payment of $12 million received from Nike USA, Inc. The associated revenue will be recognized on a straight-line basis over the life of the agreement.

ICA's overall financial position improved in 2016 as net position increased $7.8 million. Net position as of June 30, 2016 and 2015 totaled $494.7 million and $486.9 million, respectively, and is summarized as follows:

	2016	**2015**
	(in thousands)	
Net investment in capital assets	$ 246,751	$ 250,981
Restricted:		
Nonexpendable	58,758	52,707
Expendable	170,031	162,821
Unrestricted	19,217	20,404
	$ 494,757	$ 486,913

Management's Discussion and Analysis (Unaudited)--Continued

Results of Operations

ICA measures its results of operations based on certain activities, which are summarized as follows for the three years ended June 30, 2016:

	2016	**2015** (in thousands)	**2014**
Revenues:			
Spectator admissions	$ 45,127	$ 41,903	$ 50,215
Conference distributions	34,863	32,429	27,455
Corporate sponsorship and licensing royalties	23,830	22,210	22,124
Other revenues	11,073	11,969	14,613
Total operating revenues	114,893	108,511	114,407
Private gifts for other than capital and endowment purposes, current funds	7,540	6,404	6,743
Preferred seating donations	29,406	29,161	28,524
Investment income, current funds	3,674	3,249	2,978
Total Revenues	155,513	147,325	152,652
Expenses and Other Uses:			
Salaries, wages and benefits, current funds	59,789	57,745	49,904
Financial aid	22,973	20,395	19,436
Team and game	27,786	23,613	23,010
Other operating and administrative	14,709	14,501	15,179
Operations and maintenance of plant, current funds	8,646	9,598	10,055
Operating expenses, current funds	133,903	125,852	117,584
Deferred maintenance transfer	5,000	5,000	4,750
Debt service transfer	14,787	15,141	14,970
Equity transfers to the University, current funds	1,491	1,674	2,309
Total Expenses and Other Uses	155,181	147,667	139,613
Excess (deficit) of revenues over expenses and other uses	332	(342)	13,039
Debt stabilization return	2,156		4,234
Adjusted excess (deficit) of revenues over expenses and other uses	$ 2,488	$ (342)	$ 17,273

Management's Discussion and Analysis (Unaudited)--Continued

Adjusted excess of revenues over expenses and other uses increased $2.8 million in 2016 and decreased $17.6 million in 2015.

ICA's adjusted revenues increased $8.2 million in 2016 due primarily to increases in spectator admissions and conference distributions. ICA's adjusted operating revenues decreased $5.3 million in 2015 due primarily to decreases in spectator admissions and facilities revenues. In 2016, spectator admissions increased $3.2 million primarily due to an increase in football ticket demand. In 2015, spectator admissions decreased $8.3 million due to a decrease in football, men's basketball and ice hockey admissions. Conference distributions increased $2.4 million in 2016 primarily due to an increase in the postseason bowl games distribution. Conference distributions increased $5.0 million in 2015 due to increases in television rights contracts and the postseason bowl games distribution. Other revenues decreased $2.6 million in 2015 primarily due to a decrease in facilities special event rental revenue.

ICA's adjusted expenses and other uses increased $7.5 million in 2016 primarily due to increases in team and game expenses and financial aid. ICA's adjusted expenses and other uses increased $8.1 million in 2015 primarily due to increases in salaries, wages and benefits, and financial aid. Team and game expenses increased $4.2 million in 2016 due to increased travel and meal costs. Financial aid increased $2.6 million in 2016 due to the addition of cost of attendance stipends. Salaries, wages and benefits increased $7.8 million in 2015 due to contractual pay increases, ICA's merit program, the cost of employee severance and the investment in new football staff. ICA received a return of debt service transfers from the University's debt stabilization program in the amount of $2.2 million in 2016.

Statement of Cash Flows

The statement of cash flows provides additional information about ICA'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, 2016 and 2015 is as follows:

	2016	**2015**
	(in thousands)	
Net cash used in operating activities	$ (1,950)	$ (19,812)
Net cash provided by investing activities	3,290	5,315
Net cash used in capital and related financing activities	(12,132)	(15,417)
Net cash provided by noncapital financing activities	35,194	33,903
Net increase in cash equivalents	$ 24,402	$ 3,989

Cash received from operations primarily consists of spectator admissions, conference distributions and corporate sponsorships and other media rights. Cash received from noncapital financing primarily consists of private gifts and preferred seating donations. ICA continued to invest in its physical plant by devoting $12.1 million and $15.4 million in net cash for capital and related financing activities in 2016 and 2015, respectively.

Economic Factors That Will Affect the Future

ICA is continuing to make significant investments in its facilities that have required additional debt and the use of ICA cash reserves. In addition, ICA has invested in new football staff and incurred new expenses related to the cost of attendance and changes in student-athlete nutrition regulations, which have increased its operating costs. Nevertheless, ICA believes that it is well positioned to generate sufficient cash flows to finance planned facility projects and sustain continued success in its operations and support of the student-athlete and athletic department.

To ensure facilities funding requirements are met, ICA management continues to emphasize positive operating results, expanded private giving and continued use of long-term debt to support the future infrastructure and facility renewal needs of the department. In 2013, ICA initiated the South Campus Athletics project fundraising campaign, with the goal of obtaining sufficient private giving to support its plan to construct new and replacement facilities for its teams and student-athletes. Based on the success of the campaign, ICA has commenced construction of a $168 million project on the south end of the Stephen M. Ross Athletic Campus called the Athletics South Competition and Performance project. The project will add competition venues for lacrosse and track, in addition to team centers for lacrosse, track and rowing, while also addressing the needs of both soccer programs. The project also includes medical, performance science, nutritional and strength and conditioning facilities.

A major portion of ICA's revenue, such as conference media contracts and corporate sponsorship arrangements, is contractually defined for a number of years in the future. However, a significant portion of ICA's revenue base, such as gifts, football admissions and premium seat sales, is directly tied to its football program. While ICA has historically sold out the premium seats at Michigan Stadium and enjoyed football season ticket renewals of greater than 95 percent, there is no guarantee that the historical economic success of its football program will continue in the future. ICA would be negatively impacted if the football program were to experience declined success, which would likely result in decreased spectator admissions and gift revenue. Management believes the investment in new football staff will continue to secure the future economic success of the program.

Additional external risks, which may significantly impact ICA, include lawsuits involving the NCAA, grant-in-aid limits and overall student-athlete support structure. Health care, injury prevention, full cost of attendance provisions, student-athlete trust funds and professional agent representation will continue to be discussed. Furthermore, potential future landscape changes could arise in the form of additional benefits for student-athletes beyond their participation.

INTERCOLLEGIATE ATHLETICS
OF THE UNIVERSITY OF MICHIGAN

Statement of Net Position

	June 30, 2016	June 30, 2015
	(in thousands)	
Assets		
Current Assets:		
Cash equivalents on deposit with the University	**$ 137,043**	$ 112,641
Accounts receivable, net	**5,688**	5,141
Current portion of pledges receivable, net	**15,406**	11,264
Current portion of prepaid expenses and other assets	**1,480**	1,190
Total Current Assets	**159,617**	130,236
Noncurrent Assets:		
Unexpended debt proceeds on deposit with the University	**18,222**	
Endowment investments on deposit with the University	**92,111**	89,532
Pledges receivable, net	**90,133**	87,593
Prepaid expenses and other assets	**2,750**	1,250
Capital assets, net	**469,508**	463,941
Total Noncurrent Assets	**672,724**	642,316
Total Assets	**$ 832,341**	$ 772,552
Liabilities and Net Position		
Current Liabilities:		
Accounts payable and accrued expenses	**$ 12,854**	$ 6,485
Accrued compensation	**5,471**	6,944
Advance sale of game tickets	**43,819**	38,064
Current portion of unearned revenues	**3,637**	1,807
Current portion of notes payable to the University	**5,730**	5,485
Total Current Liabilities	**71,511**	58,785
Noncurrent Liabilities:		
Unearned revenues	**12,911**	2,327
Obligations for postemployment benefits	**17,913**	17,052
Notes payable to the University	**235,249**	207,475
Total Noncurrent Liabilities	**266,073**	226,854
Total Liabilities	**337,584**	285,639
Net Position:		
Net investment in capital assets	**246,751**	250,981
Restricted:		
Nonexpendable	**58,758**	52,707
Expendable	**170,031**	162,821
Unrestricted	**19,217**	20,404
Total Net Position	**494,757**	486,913
Total Liabilities and Net Position	**$ 832,341**	$ 772,552

The accompanying notes are an integral part of the financial statements.

INTERCOLLEGIATE ATHLETICS
OF THE UNIVERSITY OF MICHIGAN

Statement of Revenues, Expenses and Changes in Net Position

	Year Ended June 30, 2016	2015
	(in thousands)	
Operating Revenues		
Spectator admissions	**$ 45,127**	$ 41,903
Conference distributions	**34,863**	32,429
Corporate sponsorships and other media rights	**15,987**	15,553
Licensing royalties	**7,843**	6,657
Facilities revenues	**4,488**	6,309
Concessions, publications and parking	**3,986**	3,598
Other revenues	**2,599**	2,062
Total Operating Revenues	**114,893**	108,511
Operating Expenses		
Salaries, wages and benefits	**58,791**	58,041
Financial aid	**22,973**	20,395
Team and game	**27,786**	23,613
Other operating and administrative	**14,709**	14,501
Operations and maintenance of plant	**10,293**	10,795
Depreciation	**24,249**	24,188
Total Operating Expenses	**158,801**	151,533
Operating loss	**(43,908)**	(43,022)
Nonoperating Revenues (Expenses)		
Private gifts for other than capital and endowment purposes	**7,549**	6,416
Preferred seating donations	**29,406**	29,161
Net investment (loss) income	**(137)**	3,528
Interest expense and other, net	**(7,470)**	(9,648)
Total Nonoperating Revenues, Net	**29,348**	29,457
Loss before other revenues and transfers	**(14,560)**	(13,565)
Other Revenues		
Capital gifts	**17,464**	8,009
Private gifts for permanent endowment purposes	**6,034**	7,234
Total Other Revenues	**23,498**	15,243
Net revenues before transfers	**8,938**	1,678
Transfers to other University departments, net	**(1,094)**	(676)
Increase in net position	**7,844**	1,002
Net Position, Beginning of Year	**486,913**	485,911
Net Position, End of Year	**$ 494,757**	$ 486,913

The accompanying notes are an integral part of the financial statements.

INTERCOLLEGIATE ATHLETICS
OF THE UNIVERSITY OF MICHIGAN

Statement of Cash Flows

	Year Ended June 30, 2016	2015
	(in thousands)	
Cash Flows from Operating Activities		
Spectator admissions	**$ 50,784**	$ 40,999
Conference distributions	**34,825**	32,516
Corporate sponsorships and other media rights	**24,255**	13,150
Licensing royalties	**8,689**	6,358
Facilities revenues	**5,202**	6,281
Concessions, publications and parking	**3,760**	3,381
Other revenues	**2,739**	2,058
Payments for salaries, wages and benefits	**(60,900)**	(57,402)
Payments for financial aid	**(22,973)**	(20,395)
Payments for team and game expenses	**(25,984)**	(21,212)
Payments for other operating and administrative expenses	**(12,105)**	(14,561)
Payments for operations and maintenance of plant	**(10,242)**	(10,985)
Net Cash Used in Operating Activities	**(1,950)**	(19,812)
Cash Flows from Investing Activities		
Investment income	**3,823**	4,142
(Increase) decrease in investments on deposit with the University, net	**(533)**	1,173
Net Cash Provided by Investing Activities	**3,290**	5,315
Cash Flows from Capital and Related Financing Activities		
Capital gifts	**11,449**	17,314
Proceeds from issuance of capital debt	**34,050**	1,315
Deposit of unexpended debt proceeds with the University	**(18,222)**	
Principal payments on capital debt	**(6,031)**	(6,925)
Interest payments on capital debt	**(9,687)**	(9,633)
Debt stabilization refunds	**2,156**	
Purchases of capital assets	**(25,847)**	(17,488)
Net Cash Used in Capital and Related Financing Activities	**(12,132)**	(15,417)
Cash Flows from Noncapital Financing Activities		
Private gifts for other than capital and endowment purposes	**6,882**	5,418
Preferred seating donations	**29,406**	29,161
Transfers to other University departments, net	**(1,094)**	(676)
Net Cash Provided by Noncapital Financing Activities	**35,194**	33,903
Net increase in cash equivalents	**24,402**	3,989
Cash Equivalents on Deposit with the University, Beginning of Year	**112,641**	108,652
Cash Equivalents on Deposit with the University, End of Year	**$ 137,043**	$ 112,641

The accompanying notes are an integral part of the financial statements.

INTERCOLLEGIATE ATHLETICS
OF THE UNIVERSITY OF MICHIGAN

Statement of Cash Flows--Continued

	Year Ended June 30, 2016	2015
	(in thousands)	
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	**$ (43,908)**	$ (43,022)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation expense	**24,249**	24,188
Changes in assets and liabilities:		
Accounts receivable, net	**(547)**	(255)
Prepaid expenses and other assets	**(1,790)**	(1,328)
Accounts payable and accrued expenses	**2,489**	(82)
Accrued compensation	**(612)**	1,727
Advance sale of game tickets	**5,755**	(903)
Unearned revenues	**12,414**	(137)
Net cash used in operating activities	**$ (1,950)**	$ (19,812)

The accompanying notes are an integral part of the financial statements.

Note 1--Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation: Intercollegiate Athletics of the University of Michigan ("ICA") operates under the control of the Regents of the University of Michigan (the "University") to administer the intercollegiate athletic programs of the University. As part of the University, the assets, liabilities, revenues, expenses and changes in net position of ICA are included in the consolidated financial statements of the University. All organizations controlled by ICA, consisting of its various departments, are included in the financial statements; organizations not controlled by ICA, such as certain booster and alumni organizations, are not included in the financial statements. As part of the University, ICA is exempt from income taxes under Internal Revenue Code Sections 501(c)(3) and 115.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, as prescribed by the Governmental Accounting Standards Board ("GASB"). ICA reports as a special purpose government entity engaged primarily in business type activities, as defined by GASB, on the accrual basis. Business type activities are those that are financed in whole or in part by fees charged to external parties for goods or services.

Net position is categorized as:

- Net investment in capital assets: Capital assets, net of accumulated depreciation, unspent capital debt proceeds and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

- Restricted:

  Nonexpendable – Net position subject to externally imposed stipulations that it be maintained permanently. Such net position includes the corpus portion (historical value) of gifts to ICA's permanent endowment funds and certain investment earnings stipulated by the donor to be reinvested permanently.

  Expendable – Net position subject to externally imposed stipulations that can be fulfilled by actions of ICA pursuant to those stipulations or that expire by the passage of time. Such net position includes net appreciation of ICA's permanent endowment funds that have not been stipulated by the donor to be reinvested permanently.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

- Unrestricted: Net position not subject to externally imposed stipulations. Unrestricted net position may be designated for specific purposes by action of management or the Board of Regents or may otherwise be limited by contractual agreements with outside parties.

Adoption of New Accounting Standard: During 2016, the University adopted GASB Statement No. 72, *Fair Value Measurement and Application* ("GASB 72"). The adoption of this statement did not have a material impact on ICA's financial statements.

Summary of Significant Accounting Policies: For purposes of the statement of cash flows, ICA considers all highly liquid investments purchased with a maturity of three months or less, to be cash equivalents. Cash equivalents generally represent investments in the University Investment Pool ("UIP"), a short-term commingled pool managed by the University that can be readily liquidated to pay contractual liabilities.

ICA receives pledges and bequests of financial support from corporations, foundations and individuals. Revenue is recognized when a pledge representing an unconditional promise to pay is received and all eligibility requirements, including time requirements, have been met. In the absence of such a promise, revenue is recognized when the gift is received. Permanent endowment pledges do not meet eligibility requirements, as defined by GASB, and are not recorded as assets until the related gift is received.

Unconditional promises to give that are expected to be collected in future years are recorded at the present value of the estimated future cash flows. The discounts on these amounts are computed using risk-free interest rates applicable to the years in which the promises are made, commensurate with expected future payments. An allowance for uncollectible pledges receivable is provided based on management's judgment of potential uncollectible amounts and includes such factors as prior collection history, type of gift and nature of fundraising.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

Endowment investments primarily represent investments in the University Endowment Fund (“UEF”), a commingled pool which is invested entirely in the Long Term Portfolio, a diversified, equity-oriented investment pool managed by the University. The net asset value (“NAV”) of UEF shares is determined at the end of each calendar quarter based on the fair value of the pool. Participants may purchase or redeem UEF shares at NAV at each valuation date, subject to minimum holding and notice requirements.

Capital assets are recorded at cost or, if donated, at fair value at the date of donation. Depreciation of capital assets is provided on a straight-line method over the estimated useful lives of the respective assets, which generally range from four to forty years.

Advance sale of game tickets consists of spectator admissions collected for athletic contests scheduled for the subsequent fiscal year and therefore not earned as of the end of the current fiscal year.

Unearned revenues consist primarily of cash received from unearned sponsorships, corporations, golf course memberships and other contracts which have not yet been earned under the terms of the agreements.

Signing bonuses and other financial arrangements associated with new coaching hires are recorded as a prepaid expense and amortized in accordance with the underlying contract terms. Pursuant to this policy, the financial statements include prepaid expenses and other assets of $3,250,000 and $1,750,000 at June 30, 2016 and 2015, respectively, related to compensation agreements with coaches.

For donor restricted endowments, the Uniform Prudent Management of Institutional Funds Act, as adopted in Michigan, permits the Board of Regents to appropriate an amount of realized and unrealized endowment appreciation as determined to be prudent. The University’s policy is to retain net realized and unrealized appreciation with the endowment after spending rule distributions. Cumulative net appreciation of permanent endowment funds, which totaled $25,168,000 and $28,789,000 at June 30, 2016 and 2015, respectively, is available to meet spending policy rate distributions and is recorded in restricted expendable net position. The University’s endowment spending rule is further discussed in Note 2.

Conference distributions consist of television revenue and tournament and bowl payouts distributed to ICA by the Big Ten Conference.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

ICA records non-cash, value-in-kind trade transactions in both corporate sponsorships and other media rights revenue and team and game expense. These transactions consist primarily of athletic apparel and footwear, and amounted to $2,337,000 in 2016 and $2,474,000 in 2015.

Facilities revenues represent revenue from usage of ICA facilities.

Preferred seating donations represent an annual seating program for men’s football, basketball and ice hockey, with seat location linked to donation levels.

Team and game expenses include post-season play expenditures, net of reimbursement from the Big Ten Conference, the National Collegiate Athletic Association and sponsoring bowl organizations.

Sales tax collected on behalf of the state of Michigan on athletic event concessions revenue is recorded on a net basis.

Interest expense is recorded net of capitalized interest, gain (loss) on disposal of plant assets and any debt stabilization refunds received from the University.

Operating activities as reported in the statement of revenues, expenses and changes in net position are those that generally result from exchange transactions, such as sales of tickets for games and payments made for services or goods received. Nonexchange transactions are reported as nonoperating activities.

The preparation of 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 accompanying notes. Actual results could differ from those estimates.

Reclassifications: In 2016, ICA identified prior period errors related to the classification of Proceeds from issuance of capital debt and Principal payments on capital debt as presented within the Capital and Related Financing Activities section of the statement of cash flows. The statement of cash flows prepared for the year ended June 30, 2015 has been revised to reflect the proper classification of this activity, resulting in an increase in the amount of previously reported Proceeds from issuance of capital debt and a decrease in the amount of Principal payments on capital debt of $1,315,000.

Note 2--Cash and Investments

The University maintains centralized management for substantially all cash and investments of ICA. Cash reserves and relatively short duration assets are invested in the UIP, while longer term assets held in the UEF are invested in the University's Long Term Portfolio. Unexpended capital debt proceeds are invested by the University in overnight cash management vehicles. The UIP is principally invested in investment-grade money market securities, U.S. government and other fixed income securities and absolute return strategies. The longer investment horizon of the University's Long Term Portfolio allows for an equity-oriented strategy to achieve higher expected returns over time, and permits the use of less liquid alternative investments, providing for equity diversification beyond the stock markets.

The UEF consists of both permanent endowments and funds functioning as endowment. Permanent endowments are those funds received from donors with the stipulation that the principal remain intact 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 ICA for long-term investment purposes, but are not limited by donor stipulations requiring ICA to preserve principal in perpetuity.

The University's investment policies are governed and authorized by University Bylaws and the Board of Regents. The approved asset allocation policy for the Long Term Portfolio, in which the UEF invests, sets a general target of 80 percent equities and 20 percent fixed income securities, within a permitted range of 65 to 90 percent for equities and 10 to 35 percent for fixed income securities. Since diversification is a fundamental risk management strategy, the Long Term Portfolio is broadly diversified within these general categories. At June 30, 2016 and 2015, the Long Term Portfolio consisted of cash and equivalents (1 percent and 1 percent), fixed income securities (9 percent and 14 percent), U.S. and non-U.S. equities (14 percent and 13 percent), commingled funds (25 percent and 26 percent) and nonmarketable alternative investments (51 percent and 46 percent).

Commingled (pooled) funds held in the Long Term Portfolio include Securities and Exchange Commission regulated mutual funds and externally managed funds, limited partnerships and corporate structures which are generally unrated and unregulated. Commingled funds have liquidity (redemption) provisions, which enable the University to make full or partial withdrawals with notice, subject to restrictions on the timing and amount. Commingled funds are primarily invested in non-U.S./global equities and absolute return strategies, but also include exposure to domestic fixed income and equity securities. Certain commingled funds may use derivatives, short positions and leverage as part of their investment strategy; however, these investments are structured to limit the University's risk exposure to the amount of invested capital.

Note 2--Cash and Investments--Continued

Nonmarketable alternative investments held in the Long Term Portfolio consist of limited partnerships and similar vehicles involving an advance commitment of capital called by the general partner as needed and distributions of capital and return on invested capital as underlying strategies are concluded during the life of the partnership. These limited partnerships include venture capital, private equity, real estate, natural resources and absolute return strategies. There is not an active secondary market for these alternative investments, which are generally unrated and unregulated, and the liquidity of these investments is dependent on actions taken by the general partner.

The Long Term Portfolio holds investments denominated in foreign currencies and forward foreign exchange contracts used to manage the risk related to fluctuations in currency exchange rates between the time of purchase or sale and the actual settlement of foreign securities. Various investment managers acting for the University also use forward foreign exchange contracts in risk-based transactions to carry out their portfolio strategies. Foreign exchange risk is the risk that investments denominated in foreign currencies may lose value due to adverse fluctuations in the value of the U.S. dollar relative to foreign currencies. The Long Term Portfolio's non-U.S. dollar exposure amounted to 8 percent and 5 percent of the portfolio at June 30, 2016 and 2015, respectively.

The University's investment strategy incorporates certain financial instruments that involve, to varying degrees, elements of market risk and credit risk in excess of amounts recorded in the financial statements. Market risk is the potential for changes in the value of financial instruments due to market changes, including interest and foreign exchange rate movements and fluctuations embodied in forwards, futures and commodity or security prices. Market risk is directly impacted by the volatility and liquidity of the markets in which the underlying assets are traded. Credit risk is the possibility that a loss may occur due to the failure of a counterparty to perform according to the terms of the contract. The University's risk of loss in the event of a counterparty default is typically limited to the amounts recognized in the statement of net position and is not represented by the contract or notional amounts of the instruments.

ICA receives quarterly distributions from the UEF based on the University's endowment spending rule. At June 30, 2016 and 2015, the annual distribution rate was 4.5 percent of the one-quarter lagged seven year moving average fair value of fund shares. To protect endowment principal in the event of a prolonged market downturn, distributions are limited to 5.3 percent of the current fair value of fund shares. Monthly distributions are also made from the UIP to ICA based on the 90-day U.S. Treasury Bill rate. The University's costs to administer and grow the UEF and UIP are funded by investment returns.

Note 2--Cash and Investments--Continued

Withdrawals may be made quarterly from the UEF, with thirty days' notice, based upon University policy, generally after a five year investment period. Withdrawals may be made from the UIP on a daily basis.

GASB 72 defines fair value and establishes a framework for measuring fair value that includes a three tiered hierarchy of valuation inputs, placing a priority on those which are observable in the marketplace. Observable inputs reflect market data obtained from sources independent of the reporting entity and unobservable inputs reflect the entity's own assumptions about how market participants would value an asset or liability based on the best information available. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. The three levels of inputs, of which the first two are considered observable and the last unobservable, are as follows:

- Level 1 – Quoted prices for identical assets or liabilities in active markets that can be accessed at the measurement date

- Level 2 – Other significant observable inputs, either direct or indirect, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable; or market corroborated inputs

- Level 3 – Unobservable inputs

A significant portion of the underlying investments of the University's commingled pools include nonmarketable alternative investments and certain commingled funds described earlier in this note that are priced by managers using NAV. The proprietary valuation techniques and unobservable pricing assumptions used by these managers to estimate fair value may have a significant impact on the resulting fair value determination of these investments. However, ICA uses Level 2 inputs to measure the fair value of its investments in the University's commingled pools described in Note 1 and within this note, since shares may be purchased or sold subject to holding and notice requirements at the NAVs determined by the University.

Note 3--Pledges Receivable

The composition of pledges receivable at June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in thousands)	
Gift pledges outstanding:		
Capital	$ 103,421	$ 96,403
Operations	6,265	5,525
	109,686	101,928
Less:		
Allowance for uncollectible pledges	2,393	1,272
Unamortized discount to present value	1,754	1,799
Total pledges receivable, net	105,539	98,857
Less current portion	15,406	11,264
	$ 90,133	$ 87,593

Payments on pledges receivable at June 30, 2016 are expected to be received in the following years ended June 30 (in thousands):

2017	$ 15,859
2018	12,671
2019	10,228
2020	8,648
2021	14,121
2022 and after	48,159
	$ 109,686

As discussed in Note 1, permanent endowment pledges do not meet eligibility requirements, as defined by GASB, until the related gift is received. Accordingly, permanent endowment pledges totaling $11,879,000 and $10,391,000 at June 30, 2016 and 2015, respectively, are not recognized as assets in the accompanying financial statements. Also, pledges totaling $12,299,000 and $9,996,000 at June 30, 2016 and 2015, respectively, for the use of football suites in future years have not met time requirements and have not been recorded in the financial statements. In addition, bequest intentions and other conditional promises are not recognized as assets until the specified conditions are met because of uncertainties with regard to their realizability and valuation.

Note 4--Capital Assets

Capital assets activity for the years ended June 30, 2016 and 2015 is summarized as follows:

	2016			
	Beginning Balance	Additions (in thousands)	Retirements	Ending Balance
Land	$ 1,818			$ 1,818
Land improvements	19,050	$ 134		19,184
Infrastructure	2,840			2,840
Buildings	593,776	12,337	$ 1,944	604,169
Construction in progress, net	13,261	17,213		30,474
Equipment	9,229	499	66	9,662
	639,974	30,183	2,010	668,147
Less accumulated depreciation	176,033	24,249	1,643	198,639
	$ 463,941	$ 5,934	$ 367	$ 469,508

	2015			
	Beginning Balance	Additions (in thousands)	Retirements	Ending Balance
Land	$ 1,818			$ 1,818
Land improvements	17,483	$ 1,567		19,050
Infrastructure	2,243	597		2,840
Buildings	579,624	14,152		593,776
Construction in progress, net	13,970	(709)		13,261
Equipment	9,215	630	$ 616	9,229
	624,353	16,237	616	639,974
Less accumulated depreciation	152,309	24,188	464	176,033
	$ 472,044	$ (7,951)	$ 152	$ 463,941

In 2016, the increase in construction in progress of $17,213,000 represents the amount of capital expenditures for new projects of $29,684,000 net of capital assets placed in service of $12,471,000. In 2015, the decrease in construction in progress of $709,000 represents the amount of capital expenditures for new projects of $15,606,000 net of capital assets placed in service of $16,315,000.

Note 5--Notes Payable to the University of Michigan

Long-term debt activity for the years ended June 30, 2016 and 2015 is summarized as follows:

	2016			
	Beginning Balance	Additions	Reductions	Ending Balance
		(in thousands)		
Payable to the University	$ 212,960	$ 34,050	$ 6,031	$ 240,979
Less current portion	5,485			5,730
	$ 207,475			$ 235,249

	2015			
	Beginning Balance	Additions	Reductions	Ending Balance
		(in thousands)		
Payable to the University	$ 218,005	$ 1,315	$ 6,360	$ 212,960
Less current portion	5,600			5,485
	$ 212,405			$ 207,475

In 2016, ICA borrowed $34,050,000 to finance the construction of the Stephen M. Ross Athletics South Competition and Performance project. In 2015, ICA borrowed $1,315,000 to provide funding for the renovation and expansion of the Crisler Center.

ICA participates in the University's debt stabilization program and is charged interest at a composite fixed rate based on available variable and fixed rate debt instruments. Periodically, the University reviews payments made under the fixed rate schedules as compared to actual interest payments made by the University to outside debt holders and may utilize excess interest paid to support future strategic projects. Fixed interest rates on debt obligations outstanding at June 30, 2016 and 2015 range from 1.53 to 5.4 percent.

Note 5--Notes Payable to the University of Michigan--Continued

In 2016, ICA incurred interest costs totaling $7,085,000, which includes a reimbursement of excess interest payments of $2,156,000 under the debt stabilization program. In 2015, ICA incurred interest costs totaling $9,531,000.

Principal maturities and interest on long-term debt for the next five years and in subsequent five-year periods are as follows:

	Principal	Interest
	(in thousands)	
2017	$ 5,725	$ 9,312
2018	5,610	9,087
2019	11,415	9,276
2020	11,590	8,884
2021	11,820	8,475
2022-2026	47,295	36,567
2027-2031	45,505	28,049
2032-2036	62,770	16,997
2037-2041	36,640	4,124
2042-2046	2,525	123
	240,895	$ 130,894
Plus unamortized premiums	84	
	$ 240,979	

Note 6--Transactions with Other University of Michigan Units

Tuition and housing costs paid to other University departments in the form of financial aid amounted to $19,232,000 and $17,813,000 for 2016 and 2015, respectively. In addition, ICA paid the University Health System $533,000 and $450,000 in 2016 and 2015, respectively, for medical services provided to student athletes.

ICA also reimbursed the University for certain other services received in the years ended June 30, 2016 and 2015 as follows:

	2016	**2015**
	(in thousands)	
Utilities	$ 3,204	$ 3,600
Plant services	1,789	2,447
Security	1,691	1,692
Catering	121	981
Telecommunications	632	649
Business and finance allocation	635	617
Insurance coverage	792	594
Budget administration allocation	508	502
Other	962	658
	$ 10,334	$ 11,740

ICA provided the University with $1,416,000 and $1,670,000 in connection with the Big Ten Network distribution received from the Big Ten Conference in 2016 and 2015, respectively. The recurring allocation is derived by a formula-driven agreement based on the annual net Big Ten Network distribution up to a maximum of $2,000,000. The annual allocation is used by the University primarily to support M-PACT, a financial aid program for non-student-athlete Michigan residents. M-PACT was created to increase the amount of aid students receive in the form of grants and therefore reduce the amount of loans needed by the general student population. Amounts are recorded in the statement of revenues, expenses and changes in net position as transfers to other University departments, net.

During 2016 and 2015, ICA received $403,000 and $892,000, respectively, from the Michigan Matching Initiative for Student Support, which offered an additional incentive for donors to establish or support endowed scholarship funds. Qualifying scholarship endowment gifts were matched at 25 percent.

Certain facilities used by ICA are located on land owned by the University which is not included in these financial statements. The University does not charge ICA rent for the use of this land.

Note 7--Postemployment Benefits

ICA participates in the University's postemployment benefits plan which provides retiree health and welfare benefits; primarily medical, prescription drug, dental and life insurance coverage, to eligible retirees and their eligible dependents. Substantially all of ICA's regular employees may become eligible for these benefits if they reach retirement age while working for ICA. For employees retiring on or after January 1, 1987, contributions toward health and welfare benefits are shared between ICA and the retiree and can vary based on date of hire, date of retirement, age and coverage elections.

The University also provides income replacement benefits, retirement savings contributions and health and life insurance benefits to substantially all regular ICA employees who are enrolled in a University sponsored long-term disability plan and qualify, based on disability status while working for ICA, to receive basic or expanded long-term disability benefits. Contributions toward the expanded long-term disability plan are shared between ICA and employees and vary based on years of service, annual base salary and coverage elections. Contributions toward the basic long-term disability plan are paid entirely by ICA.

These postemployment benefits are provided through single-employer plans administered by the University. The Executive Vice Presidents of the University have the authority to establish and amend benefit provisions of the plans.

The University's annual postemployment benefits expense is actuarially determined in accordance with GASB Statement No. 45. Projections of benefits are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided and announced future changes at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point.

ICA's annual postemployment benefits expense and liability represents an allocation of ICA's relative share of the University's expense and liability, based on the method in which the retiree benefits are funded. The funding method is based upon a percentage of salary dollars of active employees that qualify for retiree benefits.

Note 7--Postemployment Benefits--Continued

Changes in the total reported liability for ICA's postemployment benefits obligations for the years ended June 30, 2016 and 2015 are summarized as follows:

	2016		
	Retiree Health and Welfare	Long-term Disability (in thousands)	Total
Balance, beginning of year	$ 16,978	$ 750	$ 17,728
Postemployment benefits expense	1,824	39	1,863
Payments of current premiums and claims	(695)	(165)	(860)
Balance, end of year	18,107	624	18,731
Less current portion	743	75	818
	$ 17,364	$ 549	$ 17,913

	2015		
	Retiree Health and Welfare	Long-term Disability (in thousands)	Total
Balance, beginning of year	$ 16,729	$ 703	$ 17,432
Postemployment benefits expense	819	177	996
Payments of current premiums and claims	(570)	(130)	(700)
Balance, end of year	16,978	750	17,728
Less current portion	607	69	676
	$ 16,371	$ 681	$ 17,052

ICA has no obligation to make contributions in advance of when insurance premiums or claims are due for payment and currently pays for postemployment benefits on a pay-as-you-go basis. ICA's obligations for postemployment benefits at June 30, 2016 and 2015 as a percentage of covered payroll of $43,021,000 and $45,347,000 was 44 and 39 percent, respectively.

Note 7--Postemployment Benefits--Continued

The University's postemployment benefits liability was calculated using the projected unit credit method. Significant actuarial methods and assumptions used in the valuation for the years ended June 30, 2016 and 2015 are as follows:

	2016	
	Retiree Health and Welfare	Long-term Disability
Discount Rate	5.58%	7.38%
Immediate/Ultimate Administrative Trend Rate	0.0%/3.0%	0.0%/3.0%
Immediate/Ultimate Medical Trend Rate	5.5%-7.0%/4.5%	5.5%-7.0%/4.5%
Immediate/Ultimate Rx Trend Rate	10.5%/4.5%	10.5%/4.5%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2014 Generational	2005 SOA Life Waiver (Modified)

	2015	
	Retiree Health and Welfare	Long-term Disability
Discount Rate	6.08%	7.88%
Immediate/Ultimate Administrative Trend Rate	0.0%/3.0%	0.0%/3.0%
Immediate/Ultimate Medical Trend Rate	6.0%-7.0%/4.5%	6.0%-7.0%/4.5%
Immediate/Ultimate Rx Trend Rate	6.5%/4.5%	6.5%/4.5%
Expected Retirement Age (Faculty/Staff/Union)	66/62/61	Not Applicable
Mortality/Termination Table	RP-2000 Generational	2005 SOA Life Waiver (Modified)

Note 8--Retirement Plan

ICA participates in the University's retirement plan, a defined contribution retirement plan through the Teachers Insurance and Annuity Association - College Retirement Equities Fund ("TIAA-CREF") and Fidelity Management Trust Company ("FMTC") mutual funds. All staff are eligible to participate in the plan based upon age and service requirements. Participants maintain individual contracts with TIAA-CREF, or accounts with FMTC, and are fully vested.

For payroll covered under the plan, eligible employees generally contribute 5 percent of their pay and ICA generally contributes an amount equal to 10 percent of employees' pay to the plan. ICA's contribution commences after an employee has completed one year of employment. Participants may elect to contribute additional amounts to the plan within specified limits that are not matched by ICA contributions. Contributions and covered payroll under the plan (excluding participant's additional contributions) for the three years ended June 30, 2016 are summarized as follows:

	2016	2015 (in thousands)	2014
ICA contributions	$ 2,461	$ 2,287	$ 2,333
Employee contributions	$ 1,289	$ 1,196	$ 1,212
Payroll covered under plan	$ 43,021	$ 45,347	$ 37,663
Total payroll	$ 47,247	$ 49,008	$ 41,201

Note 9--Commitments and Contingencies

ICA's commitments to complete construction in progress and other authorized acquisitions of property, plant and equipment amounted to $161,623,000 as of June 30, 2016, which will be funded with cash on hand, gifts and future borrowings.

VERITAS INSURANCE CORPORATION

FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2016 and 2015
with
REPORT OF INDEPENDENT AUDITORS

VERITAS INSURANCE CORPORATION

June 30, 2016 and 2015

Page(s)

Report of Independent Auditors

To the Board of Directors of
the Veritas Insurance Corporation:

We have audited the accompanying financial statements of the Veritas Insurance Corporation (the "Corporation"), a component unit of the University of Michigan, as of and for the years ended June 30, 2016 and 2015, and the related notes to the financial statements, which consist of the statements of net position and the related statements of revenues, expenses and changes in net position and of cash flows.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on the financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Corporation's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Corporation, a component unit of the University of Michigan, as of June 30, 2016 and 2015, and the changes in its financial position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP, 101 Seaport Boulevard, Boston, MA 02210
T: (617) 530-5000, F: (617) 530-5001, www.pwc.com/us

pwc

Other Matter

The accompanying management's discussion and analysis on pages 3 through 12 is required by accounting principles generally accepted in the United States of America to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

PricewaterhouseCoopers LLP

October 20, 2016

Management's Discussion and Analysis (Unaudited)

Introduction

The following discussion and analysis provides an overview of the financial position of the Veritas Insurance Corporation (the "Corporation") at June 30, 2016 and 2015 and its activities for the three fiscal years ended June 30, 2016. 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 Corporation, a wholly-owned subsidiary of the University of Michigan (the "University"), provides insurance coverage to the University. The University is the sole shareholder of the Corporation. As part of the University, the assets, liabilities, revenues, expenses and changes in net position of the Corporation are included in the consolidated financial statements of the University.

The Corporation provides direct insurance for medical professional liability, property damage, general liability (including hospital general liability) and educators' legal liability (including directors' and officers' liability). Indemnification is also provided for the University's workers' compensation and auto liability coverages.

The Corporation's insurance policies generally feature aggregate loss limits. For policies incepted in 2016 and 2015, the annual aggregate loss limit was $50 million for medical professional liability and $5 million for property damage. General liability, educators' legal liability and auto liability coverages were limited by a combined annual aggregate loss limit of $20 million.

In addition, the Corporation writes, on a direct basis, basket aggregate umbrella liability. A portion of the basket aggregate umbrella liability program is reinsured by Munich Reinsurance America, Inc. The Corporation also writes, on a direct basis, additional excess liability coverage for general liability and auto liability. This program is fully reinsured by Swiss Reinsurance Company.

Financial Highlights

For the year ended June 30, 2016, the Corporation's net position decreased $9.9 million to $48.0 million. Net investment losses decreased net position by $1.1 million, while operating revenues, net of expenses, decreased net position by $8.8 million.

As a result of favorable loss experience and investment returns in prior years, capital and surplus were sufficient to provide premium credits totaling $12.3 million in 2016. The premium credits were accrued in the accompanying financial statements at June 30, 2016.

Premium credits to be distributed as of June 30, 2016 and 2015 are as follows:

	2016	2015
	(in millions)	
Medical professional liability	$ 9.1	$ 12.5
Educators' legal liability	2.8	2.6
Property damage	0.2	0.7
General liability	0.1	0.1
Hospital premises liability	0.1	0.1
Total premium credit	$ 12.3	$ 16.0

Overview of the Financial Statements

The financial statements report information about the Corporation as a whole using accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board, which have also been used in the preparation of the Annual Statement filed with the Vermont Department of Financial Regulation. Financial statements include the Statement of Net Position, which provides information about the Corporation's financial condition at the end of the fiscal year; the Statement of Revenues, Expenses and Changes in Net Position, which presents information regarding the results of operations and changes in net position for the year; the Statement of Cash Flows, which displays information pertaining to cash receipts and disbursements during the year; and the notes to the financial statements. These statements collectively, and the discussion included herein, present the financial condition of the Corporation at June 30, 2016 and 2015, and its revenues, expenses and changes in net position and cash flows for the years then ended.

Statement of Net Position

The statement of net position presents the financial position of the Corporation at the end of the fiscal year and includes all assets and liabilities of the Corporation. The difference between total assets and total liabilities – net position – is one indicator of the current financial condition of the Corporation, while the change in net position is an indication of whether the overall financial condition has improved or worsened during the year. A comparison of the Corporation's assets, liabilities and net position at June 30, 2016 and 2015 is summarized as follows:

	2016	**2015**
	(in millions)	
Cash equivalents and investments	$ 199.2	$ 207.9
Other assets	2.3	1.9
Total assets	201.5	209.8
Reserves for losses and loss adjustment expenses	136.2	126.6
Return premiums payable to affiliated units	12.3	16.0
Other liabilities	5.0	9.3
Total liabilities	153.5	151.9
Unrestricted net position	$ 48.0	$ 57.9

Management's Discussion and Analysis (Unaudited)--Continued

Assets: The assets of the Corporation totaled $201.5 million at June 30, 2016, a decrease of $8.3 million, or 4.0 percent from the prior year. The decrease is primarily due to the excess of expenses over income and investment losses incurred during the year.

The major components of invested assets at June 30, 2016 were $250,000 in cash equivalents, $91.5 million in the University's Daily and Monthly Portfolios and $107.5 million in the University's Long Term Portfolio. The major components of invested assets at June 30, 2015 were $250,000 in cash equivalents, $95.4 million in the University's Daily and Monthly Portfolios and $112.2 million in the University's Long Term Portfolio. The asset allocations for both 2016 and 2015 are consistent with the asset allocation target ranges adopted by the Corporation's Board of Directors.

Liabilities: The major components of liabilities are reserves for losses and loss adjustment expenses ("LAE"). At June 30, 2016, reserves for losses and LAE totaled $136.2 million, an increase of $9.6 million, or 7.6 percent from the prior year. Of this amount, $48.1 million related to reserves on known claims and $88.1 million related to incurred but not reported reserves. The Corporation's reserves for losses and LAE are based upon management's best estimates, claim adjusters' determinations and actuarial valuations, discounted at a rate of 6 percent for 2016 and 2015. The increase in reserves for losses and LAE is primarily due to higher losses incurred compared to payout of claims in 2016.

Management's Discussion and Analysis (Unaudited)--Continued

The activity in the reserves for losses and LAE for the years ended June 30, 2016 and 2015 is summarized as follows:

	2016	2015
	(in millions)	
Reserves for losses and LAE, beginning of year	$ 126.6	$ 126.4
Less reinsurance recoverable on unpaid losses	1.3	1.1
Net reserves for losses and LAE, beginning of year	125.3	125.3
Incurred losses and LAE related to:		
Current year	41.7	39.5
Prior years	(5.0)	(9.6)
Total incurred losses and LAE	36.7	29.9
Total paid losses and LAE	(26.9)	(29.9)
Net reserves for losses and LAE, end of year	135.1	125.3
Reinsurance recoverable on unpaid losses	1.1	1.3
Reserves for losses and LAE, end of year	$ 136.2	$ 126.6

Reserves for losses and LAE by line of business at June 30, 2016 and 2015 are summarized as follows:

	2016	2015
Medical professional liability	76.6%	72.2%
Workers' compensation	11.4	12.5
Educators' legal liability	6.0	7.6
Property damage	3.4	4.4
Basket aggregate liability and excess insurance	1.6	2.1
Auto liability	0.5	1.0
General liability	0.3	0.1
Hospital premises liability	0.2	0.1
	100.0%	100.0%

The Corporation may return funds to the University, its policyholder, for favorable loss experience and investment returns in the form of premium credits. The Corporation's Board of Directors declares premium credits based on unrestricted net position in excess of adopted goals. One-third of the excess net position is distributed as premium credits subject to an annual review. The premium credits are accrued on financial statements for the fiscal year in which they are declared, and paid to the University in the subsequent year's premium renewals as credits. The Corporation had declared premium credits and recorded the return premiums payable totaling $12.3 million and $16.0 million at June 30, 2016 and 2015, respectively.

Net Position: Net position is unrestricted and totaled $48.0 million and $57.9 million at June 30, 2016 and 2015, respectively. This is in excess of the $250,000 minimum unimpaired paid-in capital and surplus required by the state of Vermont. The decrease in 2016 is due primarily to higher claims expenses and investment losses incurred during the year.

The Corporation's net position distribution policy includes the potential for premium credits, and allows for a one-time dividend when audited balances of net position are such that the reserve to net position ratio is lower than 2:1. All dividends are subject to approval by the Vermont Department of Financial Regulation.

Statement of Revenues, Expenses and Changes in Net Position

The statement of revenues, expenses and changes in net position for the three years ended June 30, 2016 is summarized as follows:

	2016	**2015** (in millions)	**2014**
Direct written premiums	$ 41.6	$ 41.5	$ 40.4
Change in unearned premiums	(0.2)	0.1	
Returned premiums	(12.3)	(16.0)	(13.1)
Ceded written premiums expired	(0.9)	(1.0)	(1.1)
Total operating revenues	28.2	24.6	26.2
Losses and loss adjustment expenses	36.7	29.9	32.5
Other operating expenses	0.3	0.2	0.2
Total operating expenses	37.0	30.1	32.7
Operating loss	(8.8)	(5.5)	(6.5)
Non-operating (expenses) revenues	(1.1)	4.8	23.8
(Decrease) increase in net position	$ (9.9)	$ (0.7)	$ 17.3

The Corporation's operating revenues totaled $28.2 million in 2016, compared to $24.6 million in 2015, an increase of $3.6 million, or 14.6 percent. The increase is primarily due to lower returned premiums as the $12.3 million in premium credits declared in 2016 were $3.7 million lower than in the prior year. The direct written premium contributions from the University are based on actuarially projected needs using loss data valued six to ten months prior to the inception of the policy. This loss data is adjusted for loss trend and exposure changes which include a factor for inflation. Based on these projections, the direct written premiums needed for 2016 were $0.1 million higher than 2015.

Management's Discussion and Analysis (Unaudited)--Continued

Returned premiums are the Corporation's declared premium credits, a distribution of unrestricted net position in excess of adopted goals. Returned premiums of $12.3 million and $16.0 million during 2016 and 2015, respectively, were due to favorable loss development in several programs and favorable investment returns.

Gross written premiums net of premium credits by line of business for the three years ended June 30, 2016 are summarized as follows:

	2016	2015	2014
Medical professional liability	57.5%	54.4%	56.0%
Workers' compensation	20.2	21.1	19.4
Educators' legal liability	5.4	6.4	5.1
Property damage	11.2	11.0	12.4
Basket aggregate liability and excess insurance	4.0	5.1	5.3
Auto liability	1.4	1.6	1.5
General liability	0.3	0.3	0.3
Hospital premises liability		0.1	
	100.0%	100.0%	100.0%

Incurred losses and LAE for the three years ended June 30, 2016 are summarized as follows:

	2016	2015 (in millions)	2014
Incurred losses and LAE related to:			
Current year	$ 41.7	$ 39.5	$ 37.3
Prior years	(5.0)	(9.6)	(4.8)
Total incurred losses and LAE	$ 36.7	$ 29.9	$ 32.5

In 2016, total incurred losses and LAE increased $6.8 million, or 22.7 percent, to $36.7 million. The increase is primarily due to a combination of increased exposures and expected severity resulting in an increase in current policy year incurred losses to $41.7 million, and a $5.0 million decrease in loss and LAE expenses related to favorable claim development of prior policy year incurred losses.

In 2016, favorable prior year loss development totaling $5.0 million is mainly attributable to favorable development in Medical Professional Liability (“MPL”). For MPL, prior year ultimate losses decreased by $4.8 million mainly due to more favorable development than actuarially expected for policy years 2010/11, 2011/12, 2012/13, 2013/14 and 2014/15. Property losses decreased $1.9 million mainly due to recovery on a major claim in policy year 2012/13, more favorable development than actuarially expected for policy year 2014/15 and a reduction in the number of significant claims received during policy year 2015/16. Workers Compensation (“WC”) losses increased by $1.3 million primarily due to unfavorable actuarial development for policy year 2014/15 and an increase in settlement costs due to Medicare Set Aside requirements. Other lines of business in aggregate saw unfavorable development of $0.4 million.

In 2015, favorable prior year loss development totaling $9.6 million is mainly attributable to favorable development in MPL. For MPL, prior year ultimate losses decreased by $10.1 million mainly due to more favorable development than actuarially expected for policy years 2010/11, 2011/12, 2012/13, 2013/14 and 2014/15. Property losses decreased $2.4 million mainly due to large recoveries on two claims in policy years 2012/13 and 2013/14. WC losses increased by $2.1 million due to the emergence of one claim from policy year 2013/14. Other lines of business in aggregate saw unfavorable development of $0.8 million.

Non-operating revenues, representing net investment income, decreased from $4.8 million in 2015 to a net investment loss of $1.1 million in 2016, a reduction of $5.9 million. This decrease was primarily a result of deteriorating performance in the Long Term Portfolio as compared to the prior year.

Statement of Cash Flows

The statement of cash flows provides additional information about the Corporation'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, 2016 and 2015 is as follows:

	2016	2015
	(in millions)	
Cash received from operations	$ 25.6	$ 30.8
Cash expended for operations	(33.2)	(31.2)
Net cash used in operating activities	(7.6)	(0.4)
Net cash provided by investing activities	7.6	0.4
Net change in cash equivalents	$ -	$ -

The primary source of cash from operations is the collection of premiums. Premiums collected totaled $25.6 million in 2016 and $28.4 million in 2015. The $2.8 million decrease in premiums collected is the result of a $2.8 million increase in returned premiums paid, which are based on each prior year's premium credit accruals.

Cash expended for operating activities, which primarily represents payment of losses and LAE, ceded reinsurance premiums and other underwriting expenses, totaled $33.2 million in 2016, as compared to $31.2 million in 2015. The increase is due to increased payments for losses and LAE paid in the current year.

Cash provided from investing activities increased $7.2 million in 2016 compared to 2015. This was primarily due to a higher volume of sales and maturities of investments to support operating activities.

Economic Factors That Will Affect the Future

The Corporation faces several factors which directly or indirectly affect its financial position and operations. State and Federal regulations relating to insurance liabilities could change. In addition, the insurance marketplace is competitive and the Corporation's ability to place coverage in the insurance market and purchase reinsurance may change.

The Corporation employs an investment strategy that balances asset allocation between current and noncurrent investments. Current assets are invested in the University's Daily and Monthly Portfolios, while noncurrent assets are invested in the University's Long Term Portfolio. The strategy seeks to maximize total return at the appropriate level of risk over a time horizon commensurate with payment patterns of the Corporation's loss retentions. However, investment results looking forward are subject to future market conditions and volatility.

The Corporation discounts reserves for losses based on expected investment returns and actuarially determined payment patterns. A discount rate of 6 percent was used for each of the years ended 2016, 2015 and 2014. This estimate may change based on periodic assessment of investment strategies, actual returns and future market conditions. The discount rate was most recently reviewed and affirmed by the Corporation's Board of Directors at their May 2, 2016 meeting.

The Corporation acquires certain reinsurance and excess insurance coverage in the commercial market. In recent years, the Corporation has been able to access adequate levels of commercial reinsurance and excess insurance at moderate premium costs. However, insurance industry results due to underwriting performance, investment returns, and major accidents and disasters could impact the cost of, and the Corporation's value assessment of, commercial risk transfer options in the future.

VERITAS INSURANCE CORPORATION

Statement of Net Position

	June 30, 2016	June 30, 2015
Assets		
Current Assets:		
Cash equivalents	**$ 250,000**	$ 250,000
Investments on deposit with the University	**91,467,750**	95,447,146
Losses receivable from the University	**16,462**	29,178
Premium tax recoverable	**35,041**	45,518
Prepaid premium tax	**11,224**	10,792
Prepaid reinsurance premiums	**316,741**	315,833
Reinsurance recoverable on paid losses	**823,149**	214,116
Total Current Assets	**92,920,367**	96,312,583
Noncurrent Assets:		
Investments on deposit with the University	**107,520,380**	112,166,527
Reinsurance recoverable on unpaid losses	**1,072,935**	1,320,939
Total Noncurrent Assets	**108,593,315**	113,487,466
Total Assets	**$ 201,513,682**	$ 209,800,049
Liabilities and Net Position		
Current Liabilities:		
Reserves for losses and loss adjustment expenses	**$ 43,102,964**	$ 38,005,709
Return premiums payable to affiliated units	**12,295,000**	15,971,354
Unearned premium reserves	**4,042,991**	3,854,741
Losses payable and accrued liabilities	**887,021**	5,477,590
Total Current Liabilities	**60,327,976**	63,309,394
Noncurrent Liabilities:		
Reserves for losses and loss adjustment expenses	**93,143,369**	88,580,983
Total Liabilities	**153,471,345**	151,890,377
Net Position:		
Unrestricted	**48,042,337**	57,909,672
Total Net Position	**48,042,337**	57,909,672
Total Liabilities and Net Position	**$ 201,513,682**	$ 209,800,049

The accompanying notes are an integral part of the financial statements.

VERITAS INSURANCE CORPORATION

Statement of Revenues, Expenses and Changes in Net Position

	Year Ended June 30, 2016	2015
Operating Revenues		
Gross direct written premiums	**$ 41,594,998**	$ 41,527,242
Change in unearned premiums	**(188,250)**	57,331
Total direct written premiums earned	**41,406,748**	41,584,573
Returned premiums	**(12,295,000)**	(15,971,354)
Net direct earned premiums	**29,111,748**	25,613,219
Ceded written premiums	**(950,226)**	(947,500)
Change in prepaid reinsurance	**908**	(37,967)
Total ceded written premiums expired	**(949,318)**	(985,467)
Net earned premiums	**28,162,430**	24,627,752
Total Operating Revenues	**28,162,430**	24,627,752
Operating Expenses		
Losses and loss adjustment expenses	**36,760,393**	29,855,117
Management fees	**58,856**	68,095
Premium tax	**97,596**	100,763
Other expenses	**76,627**	87,125
Total Operating Expenses	**36,993,472**	30,111,100
Operating loss	**(8,831,042)**	(5,483,348)
Nonoperating Revenues (Expenses)		
Net investment (loss) income	**(1,036,293)**	4,746,930
Total Nonoperating (Expenses) Revenues	**(1,036,293)**	4,746,930
Decrease in net position	**(9,867,335)**	(736,418)
Net Position, Beginning of Year	**57,909,672**	58,646,090
Net Position, End of Year	**$ 48,042,337**	$ 57,909,672

The accompanying notes are an integral part of the financial statements.

VERITAS INSURANCE CORPORATION

Statement of Cash Flows

	Year Ended June 30, 2016	2015
Cash Flows from Operating Activities		
Insurance premiums collected, net	**$ 25,623,644**	$ 28,382,241
Payments for losses and loss adjustment expenses	**(26,852,749)**	(29,881,076)
Receipts for recoverable losses	**(609,033)**	(85,869)
Payments for net ceded reinsurance premiums	**(950,226)**	(947,500)
Payments for other expenses	**(135,483)**	(151,720)
Payments for premium tax	**(87,551)**	(96,063)
Net cash in transit for receipts and payments	**(4,577,852)**	2,374,948
Net Cash Used in Operating Activities	**(7,589,250)**	(405,039)
Cash Flows from Investing Activities		
Proceeds from sales and maturities of investments	**56,623,826**	50,141,662
Purchases of investments	**(55,741,416)**	(59,419,722)
Investment income	**6,706,840**	9,683,099
Net Cash Provided by Investing Activities	**7,589,250**	405,039
Net change in cash equivalents	**-**	-
Cash Equivalents, Beginning of Year	**250,000**	250,000
Cash Equivalents, End of Year	**$ 250,000**	$ 250,000
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	**$ (8,831,042)**	$ (5,483,348)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Changes in assets and liabilities:		
Losses receivable from the University	**12,716**	(469)
Premium tax recoverable	**10,477**	4,433
Prepaid premium tax	**(432)**	267
Prepaid reinsurance premiums	**(908)**	37,967
Reinsurance recoverable on paid losses	**(609,033)**	(85,869)
Reinsurance recoverable on unpaid losses	**248,004**	(182,349)
Reserves for losses and loss adjustment expenses	**9,659,641**	156,390
Return premiums payable to affiliated units	**(3,676,354)**	2,826,354
Unearned premium reserves	**188,250**	(57,331)
Losses payable and accrued liabilities	**(4,590,569)**	2,378,916
Net cash used in operating activities	**$ (7,589,250)**	$ (405,039)

The accompanying notes are an integral part of the financial statements.

Note 1--Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation: The Veritas Insurance Corporation (the "Corporation"), domiciled in Vermont, is a wholly-owned captive insurance subsidiary of the University of Michigan (the "University"). The University is the sole shareholder of the Corporation. The Corporation is considered to be an integral part of the University. As a part of the University, the assets, liabilities, revenues, expenses and changes in net position of the Corporation are included in the consolidated financial statements of the University. As a wholly-owned subsidiary of the University, the Corporation is exempt from federal income taxes under the provisions of Sections 501(c)(3) and 115(a) of the Internal Revenue Code.

The Corporation provides direct insurance for medical professional liability, property damage, general liability (including hospital general liability) and educators' legal liability (including directors' and officers' liability). Indemnification is also provided for the University's workers' compensation and auto liability coverages.

The Corporation's insurance policies generally feature aggregate loss limits. For policies incepted in 2016 and 2015, the annual aggregate loss limit was $50,000,000 for medical professional liability and $5,000,000 for property damage. General liability, educators' legal liability and auto liability coverages were limited by a combined annual aggregate loss limit of $20,000,000.

In addition, the Corporation writes, on a direct basis, basket aggregate umbrella liability. A portion of the basket aggregate umbrella liability program is reinsured by Munich Reinsurance America, Inc. The Corporation also writes, on a direct basis, additional excess liability coverage for general liability and auto liability. This program is fully reinsured by Swiss Reinsurance Company. For insurance written and reinsurance ceded with a policy term different from the financial reporting period, unearned premium and prepaid reinsurance is recognized for the unexpired terms of the policies in force.

All coverages are provided on an occurrence basis with the exception of educators' legal liability which is provided on a claims-made basis.

The Corporation maintains $250,000 in cash equivalents to meet the state of Vermont's minimum unimpaired paid-in capital and surplus requirement for a single parent captive insurance company.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, as prescribed by the Governmental Accounting Standards Board ("GASB"), which have also been used in the preparation of the Annual Statement filed with the Vermont Department of Financial Regulation. The Corporation reports as a special purpose government entity engaged primarily in business type activities, as defined by GASB, on the accrual basis. Business type activities are those that are financed in whole or in part by fees charged to external parties for goods or services.

Adoption of New Accounting Standard: During 2016, the University adopted GASB Statement No. 72, *Fair Value Measurement and Application* ("GASB 72"). The adoption of this statement did not have a material impact on the Corporation's financial statements.

Summary of Significant Accounting Policies: For purposes of the statement of cash flows, the Corporation considers all highly liquid investments purchased with a maturity of three months or less, to be cash equivalents.

Investments are reported in both the current and noncurrent sections of the statement of net position. Current investments are those funds invested in the University's Daily and Monthly Portfolios, and can be readily liquidated to pay contractual liabilities. Noncurrent investments are those funds invested in the University's Long Term Portfolio, and are considered by management to be of a long duration.

Investments in marketable securities held indirectly through participation in the Daily and Monthly Portfolios and Long Term Portfolio are carried at fair value as established by the major securities markets. Purchases and sales of investments are accounted for on the trade date basis. Investment income is recorded on the accrual basis. Realized and unrealized gains and losses are reported in investment income.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

Investments in nonmarketable limited partnerships, held indirectly through participation in the Long Term Portfolio, are generally carried at fair value provided by the management of the investment partnerships as of June 30, 2016 and 2015. As these investments are not readily marketable, the estimated value is subject to uncertainty, and therefore, may differ from the value that would have been used had a ready market for these investments existed.

Derivative instruments, such as financial futures, forward foreign exchange contracts and interest rate swaps held indirectly through participation in the Daily and Monthly Portfolios and Long Term Portfolio, are recorded on the contract date and are carried at fair value using listed price quotations or amounts that approximate fair value. Investments in the Long Term Portfolio denominated in foreign currencies are translated into U.S. dollar equivalents using year-end spot foreign currency exchange rates. Purchases and sales of investments denominated in foreign currencies and related income are translated at the spot exchange rate on the transaction dates.

The reserves for losses and loss adjustment expenses ("LAE") are reported gross of reinsurance and include case basis estimates of reported losses, plus supplemental amounts related to incurred but not reported losses. The reserves are based upon management's best estimate, which includes claim adjusters' valuations and actuarial determinations, and are discounted to present value. The interest rate used to discount reserves at June 30, 2016 and 2015 was 6 percent, which reflects management's best estimate of the total portfolio rate of return. Future adjustments to these amounts resulting from the continuous review process, as well as differences between estimates and ultimate losses, will be reflected in the statement of revenues, expenses and changes in net position when such adjustments become known.

In the normal course of business, the Corporation seeks to reduce the losses that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Ceded written premiums are recognized pro-rata over the term of the underlying reinsurance policy. Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policy. Amounts recoverable from reinsurers for losses paid by the Corporation as of the statement date are recorded as a current asset. Estimated amounts recoverable from reinsurers related to noncurrent reserves for losses are recorded as a noncurrent asset. The Corporation is contingently liable should the reinsurers become unable to meet their contractual obligations.

Note 1--Organization and Summary of Significant Accounting Policies--Continued

The Corporation's policy for defining operating activities as reported on the statement of revenues, expenses and changes in net position are those that generally result from the exchange of premiums and payment of claims. The Corporation's operating activities primarily include the receipt and payment of premiums, and the reserve for and payment of claims.

Premiums are earned and reinsurance premiums are expensed on a monthly pro-rata basis over the terms of the underlying insurance policies. Unearned premium reserves and prepaid reinsurance premiums represent that portion of premiums written or ceded applicable to the unexpired terms of the policies in force.

Premium taxes are expensed over the terms of the policies to which they relate. Accordingly, prepaid premium tax is established for the portion of those premium taxes applicable to the unexpired period of the policies in force.

The Corporation distributes, in the form of returned premium credits, unrestricted net position in excess of adopted goals. One-third of the excess net position is distributed as premium credits subject to an annual review. The distribution policy includes guidelines for declaring dividends, which allows for a one-time dividend when audited balances of net position are such that the reserve to net position ratio is lower than 2:1. All premium credits and dividend declarations are at the discretion of the Board of Directors (the "Board") and dividends are subject to prior approval from the Vermont Department of Financial Regulation. Premium credits of $12,295,000 and $15,971,354 were declared by the Board in 2016 and 2015, respectively.

The preparation of 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. The most significant areas that require management estimates relate to the reserves for losses and loss adjustment expenses.

Note 2--Cash and Investments

The Board has adopted an asset allocation target range of 45-55 percent to cash equivalents and fixed income securities and 45-55 percent to equity-oriented strategies, with $250,000 to be maintained in cash equivalents to meet the State of Vermont's minimum unimpaired paid-in capital and surplus requirement.

Substantially all of the cash equivalents and investments of the Corporation are invested in the University's centrally managed investment pools. Cash reserves and relatively short duration assets are invested in the University's Daily and Monthly Portfolios, while longer term assets are invested in the University's Long Term Portfolio. The Daily and Monthly Portfolios are principally invested in investment-grade money market securities, U.S. Government and other fixed income securities and absolute return strategies. The longer investment horizon of the Long Term Portfolio allows for an equity-oriented strategy to achieve higher expected returns over time, and permits the use of less liquid alternative investments, providing for equity diversification beyond the stock markets.

The Corporation's cash equivalents and investments at June 30, 2016 and 2015 are summarized as follows:

	Amortized Cost	**Unrealized Gains**	**Fair Value**
June 30, 2016			
Cash equivalents	$ 250,000		$ 250,000
Daily and Monthly Portfolios	87,969,396	$ 3,498,354	91,467,750
Long Term Portfolio	97,609,266	9,911,114	107,520,380
	$ 185,828,662	$ 13,409,468	$ 199,238,130
June 30, 2015			
Cash equivalents	$ 250,000		$ 250,000
Daily and Monthly Portfolios	91,970,987	$ 3,476,159	95,447,146
Long Term Portfolio	93,718,094	18,448,433	112,166,527
	$ 185,939,081	$ 21,924,592	$ 207,863,673

Note 2--Cash and Investments--Continued

At June 30, 2016 and 2015, the Daily and Monthly Portfolios were comprised of 17 percent and 8 percent money market securities, 58 percent and 64 percent fixed income securities and the remaining 25 percent and 28 percent in fixed income oriented externally managed commingled funds, limited partnerships and other investments providing additional diversification benefits to the pools. Money market securities include mutual funds, overnight pooled vehicles managed by the University's custodian and short term highly liquid securities generally maturing in 90 days or less. Of the fixed income securities, 98 percent were rated investment grade, and 71 percent consisted of U.S. Treasury and government agencies and non-U.S. government securities rated AAA/Aaa at June 30, 2016, compared to 94 percent and 72 percent, respectively, at June 30, 2015. Fixed income securities considered investment grade are those rated at least BBB and Baa by two nationally recognized statistical rating organizations, Standard and Poor's and Moody's.

Effective duration is a commonly used measure of interest rate risk, incorporating a security's yield, coupon, final maturity, call features and other imbedded options into one number expressed in years that indicates how price-sensitive a security or portfolio of securities is to changes in interest rates. This measure indicates the approximate percentage change in fair value expected for a one percent change in interest rates. The weighted average effective duration of the fixed income securities in the Daily and Monthly Portfolios was 1.7 years at both June 30, 2016 and 2015.

The University's investment policies are governed and authorized by University Bylaws and the Board of Regents. The approved asset allocation policy for the Long Term Portfolio sets a general target of 80 percent equities and 20 percent fixed income securities, within a permitted range of 65 to 90 percent for equities and 10 to 35 percent for fixed income securities. Since diversification is a fundamental risk management strategy, the Long Term Portfolio is more broadly diversified within these general categories. At June 30, 2016 and 2015, the Long Term Portfolio consisted of cash and equivalents (1 percent and 1 percent), fixed income securities (9 percent and 14 percent), U.S. and non-U.S. equities (14 percent and 13 percent), commingled funds (25 percent and 26 percent) and nonmarketable alternative investments (51 percent and 46 percent).

Commingled (pooled) funds held in the Long Term Portfolio and Monthly Portfolio include Securities and Exchange Commission regulated mutual funds and externally managed funds, limited partnerships and corporate structures which are generally unrated and unregulated. Commingled funds have liquidity (redemption) provisions, which enable the University to make full or partial withdrawals with notice, subject to restrictions on the timing and amount. Commingled funds are primarily invested in non-U.S./global equities and absolute return strategies, but also include exposure to domestic fixed income and equity securities. Certain commingled funds may use derivatives, short positions and leverage as part of their investment strategy; however, these investments are structured to limit the University's risk exposure to the amount of invested capital.

Note 2--Cash and Investments--Continued

Nonmarketable alternative investments held in the Long Term Portfolio and Monthly Portfolio consist of limited partnerships and similar vehicles involving an advance commitment of capital called by the general partner as needed and distributions of capital and return on invested capital as underlying strategies are concluded during the life of the partnership. These limited partnerships include venture capital, private equity, real estate, natural resources and absolute return strategies. There is not an active secondary market for these alternative investments, which are generally unrated and unregulated, and the liquidity of these investments is dependent on actions taken by the general partner.

The Long Term Portfolio holds investments denominated in foreign currencies and forward foreign exchange contracts used to manage the risk related to fluctuations in currency exchange rates between the time of purchase or sale and the actual settlement of foreign securities. Various investment managers acting for the University also use forward foreign exchange contracts in risk-based transactions to carry out their portfolio strategies. Foreign exchange risk is the risk that investments denominated in foreign currencies may lose value due to adverse fluctuations in the value of the U.S. dollar relative to foreign currencies. The Long Term Portfolio’s non-U.S. dollar exposure amounted to 8 percent and 5 percent of the portfolio at June 30, 2016 and 2015, respectively.

The University's investment strategy incorporates certain financial instruments that involve, to varying degrees, elements of market risk and credit risk in excess of amounts recorded in the financial statements. Market risk is the potential for changes in the value of financial instruments due to market changes, including interest and foreign exchange rate movements and fluctuations embodied in forwards, futures and commodity or security prices. Market risk is directly impacted by the volatility and liquidity of the markets in which the underlying assets are traded. Credit risk is the possibility that a loss may occur due to the failure of a counterparty to perform according to the terms of the contract. The University's risk of loss in the event of a counterparty default is typically limited to the amounts recognized in the statement of net position and is not represented by the contract or notional amounts of the instruments.

Note 2--Cash and Investments--Continued

GASB 72 defines fair value and establishes a framework for measuring fair value that includes a three tiered hierarchy of valuation inputs, placing a priority on those which are observable in the marketplace. Observable inputs reflect market data obtained from sources independent of the reporting entity and unobservable inputs reflect the entity's own assumptions about how market participants would value an asset or liability based on the best information available. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. The three levels of inputs, of which the first two are considered observable and the last unobservable, are as follows:

- Level 1 – Quoted prices for identical assets or liabilities in active markets that can be accessed at the measurement date

- Level 2 – Other significant observable inputs, either direct or indirect, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted prices that are observable; or market corroborated inputs

- Level 3 – Unobservable inputs

A significant portion of the underlying investments of the University's commingled pools include nonmarketable alternative investments and certain commingled funds described earlier in this note that are priced by managers using net asset value. The proprietary valuation techniques and unobservable pricing assumptions used by these managers to estimate fair value may have a significant impact on the resulting fair value determination of these investments. However, the Corporation uses Level 2 inputs to measure the fair value of its investments in the University's commingled pools, since shares may be purchased or sold subject to holding and notice requirements at the net asset values determined by the University.

Note 3--Reserves for Losses and Loss Adjustment Expenses

Activity in the reserves for losses and LAE for the years ended June 30, 2016 and 2015 is summarized as follows:

	2016	2015
Reserves for losses and LAE, beginning of year	$ 126,586,692	$ 126,430,302
Less reinsurance recoverable on unpaid losses	1,320,939	1,138,590
Net reserves for losses and LAE, beginning of year	125,265,753	125,291,712
Add incurred losses and LAE related to:		
Current year	41,722,126	39,444,596
Prior years	(4,961,733)	(9,589,479)
Total incurred losses and LAE	36,760,393	29,855,117
Less paid losses and LAE related to:		
Current year	3,242,698	2,646,279
Prior years	23,610,051	27,234,797
Total paid losses and LAE	26,852,749	29,881,076
Net reserves for losses and LAE, end of year	135,173,397	125,265,753
Reinsurance recoverable on unpaid losses	1,072,936	1,320,939
Reserves for losses and LAE, end of year	136,246,333	126,586,692
Less current portion	43,102,964	38,005,709
	$ 93,143,369	$ 88,580,983

The liabilities for losses and LAE reserves are determined by actuarial estimates of ultimate reported losses based upon the Corporation's historical and industry loss experience. The Corporation discounted its liabilities for loss and LAE reserves using a rate of 6 percent at June 30, 2016 and 2015.

Note 3--Reserves for Losses and Loss Adjustment Expenses--Continued

The payment pattern utilized for loss reserve discounting purposes has been actuarially determined. The effects of the practice of discounting reserves have been to reduce liabilities and increase unrestricted net position by $21,328,650 and $19,443,096 at June 30, 2016 and 2015, respectively.

In 2016, incurred losses and LAE related to policies incepted during the year increased $2,277,530. Incurred losses and LAE related to prior years decreased $4,961,733 due to net favorable loss development. Medical professional liability decreased $4,784,803 and property damage decreased $1,870,608; which was offset by a workers compensation increase of $1,333,992 and Educator's legal liability increase of $47,715. The remaining lines of coverage provided combined favorable development of $311,971. The net favorable development is primarily due to claims experience reporting lower than previously projected for recent prior policy years.

In 2015, incurred losses and LAE related to policies incepted during the year increased $2,132,381. Incurred losses and LAE related to prior years decreased $9,589,479 due to net favorable loss development. Medical professional liability decreased $10,051,570 and property damage decreased $2,466,601; which was offset by a workers compensation increase of $2,138,967 and Educator's legal liability increase of $466,364. The remaining lines of coverage provided combined favorable development of $323,361. The net favorable development is primarily due to claims experience reporting lower than previously projected for recent prior policy years.

Note 4--Transactions with the University of Michigan

All premiums written and losses and loss adjustment expenses incurred result from insurance coverage written with the University.

For the years ended June 30, 2016 and 2015, the University provided claims administration and risk management services, with an approximate value of $7,790,000 and $7,240,000, respectively, at no cost to the Corporation. The increase in 2016 was primarily driven by planned addition of staff/claim adjusters and software upgrade related consulting expenses.

The University contracts with a qualified risk consultant for actuarial services to assist in the projection and valuation of the Corporation's losses. The University also contracts for insurance brokerage services which assist the Corporation in placing ceded reinsurance in the commercial market. Fees paid for actuarial and brokerage services are included in the risk management services provided by the University at no cost to the Corporation.

Return premiums payable to the University were $12,295,000 and $15,971,354 at June 30, 2016 and 2015, respectively, as more fully described in Note 1.

Note 5--Unrestricted Net Position

The Corporation is required to file an Annual Statement with the Vermont Department of Financial Regulation. There were no differences in net position and changes in net position between the audited financial statements and the Annual Statement for the years ended June 30, 2016 and 2015.

Unrestricted net position at June 30, 2016 and 2015 is summarized as follows:

	2016	**2015**
Common stock, par value $1,000 per share - authorized, issued and outstanding 1,000 shares	$ 1,000,000	$ 1,000,000
Additional paid-in capital	4,454,333	4,454,333
Retained earnings	42,588,004	52,455,339
	$ 48,042,337	$ 57,909,672