Approved by the Regents
October 19, 2017

THE UNIVERSITY OF MICHIGAN
REGENTS COMMUNICATION

ACTION REQUEST

SUBJECT: The University of Michigan Financial Statements for the Year Ended June 30, 2017

ACTION REQUESTED: Adoption of Financial Statements

The Board of Regents has electronically received the University's consolidated audited financial statements for fiscal year 2017, as well as separate audited financial statements for the University of Michigan Hospitals, Intercollegiate Athletics, and the Veritas Insurance Corporation. The Finance, Audit and Investment Committee of the Board has also 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 2017

UNIVERSITY OF MICHIGAN

CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2017
with
REPORT OF INDEPENDENT AUDITORS

UNIVERSITY OF MICHIGAN

June 30, 2017

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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 and its subsidiaries (the "University"), which comprise the consolidated statement of net position as of June 30, 2017, and the related consolidated statements of revenues, expenses and changes in net position and of cash flows for the year then ended.

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 audit. We conducted our audit 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.

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Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the University of Michigan and its subsidiaries as of June 30, 2017, and the changes in their financial position and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1 to the consolidated financial statements, the University changed the manner in which it accounts for postemployment benefits other than pensions in 2017. Our opinion is not modified with respect to this matter.

Other Matter

The accompanying management's discussion and analysis on pages 3 through 25 and the accompanying supplemental information on pages 69 through 71 are 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 audit 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 19, 2017

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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, 2017 and 2016 and its activities for the two fiscal years ended June 30, 2017. 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 8,000 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 the University of Michigan Hospitals, the University's Medical School, Michigan Health Corporation, a wholly-owned corporation created for joint venture and managed care initiatives, and UM Health, a wholly-owned corporation created to hold and develop the University's statewide network of hospitals, hospital joint ventures and other hospital affiliations. The University's health system currently includes four hospitals as well as numerous health centers and outpatient clinics.

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.

On December 15, 2016, the University completed an affiliation with Metropolitan Health Corporation ("Metro Health"), a community health care provider in west Michigan, pursuant to which UM Health became the sole corporate member of Metro Health. In addition to its 208-bed hospital, Metro Health has neighborhood outpatient clinics and offices throughout west Michigan to serve the greater Grand Rapids area. In accordance with Governmental Accounting Standards Board ("GASB") Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, this combination is included in the financial statements as if it occurred at the beginning of the earliest period presented.

Financial Highlights

The University's financial position remains strong, with total assets and deferred outflows of $20.8 billion and total liabilities and deferred inflows of $7.4 billion at June 30, 2017. Net position, which represents the residual interest in the University's total assets and deferred outflows after total liabilities and deferred inflows are deducted, totaled $13.4 billion at June 30, 2017. Changes in net position represent the University's results of operations and are summarized for the year ended June 30, 2017 as follows (in millions):

Operating revenues and educational appropriations	$ 7,480
Private gifts for operating activities	179
Operating and net interest expenses	(7,976)
	(317)
Net investment income	1,415
Endowment, capital gifts and grants, and other	178
Increase in net position	$ 1,276

Net position has been restated at July 1, 2016 for the affiliation with Metro Health and the adoption of GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* ("GASB 75"), and is summarized as follows (in millions):

Net position at June 30, 2016	$ 13,001
Affiliation with Metro Health	80
Adoption of GASB 75	(930)
Net position at July 1, 2016, as restated	$ 12,151

For purposes of management's discussion and analysis, comparative data for the statement of net position has been provided by combining Metro Health with the University and reflecting the adoption of GASB 75 at June 30, 2016. Certain balances as of June 30, 2016 have been reclassified to conform with current year presentations.

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 continued pressure on 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 $318 million in 2017. 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 primarily 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 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, deferred outflows, liabilities and deferred inflows of the University. The difference between total assets and deferred outflows as compared to total liabilities and deferred inflows – 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. The University’s assets, deferred outflows, liabilities, deferred inflows and net position at June 30, 2017 and 2016 are summarized as follows:

	2017	2016
	(in millions)	
Current assets	$ 2,696	$ 2,545
Noncurrent assets:		
Endowment, life income and other investments	11,323	10,109
Capital assets, net	6,045	5,948
Other	439	346
Total assets	20,503	18,948
Deferred outflows	349	30
Total assets and deferred outflows	20,852	18,978
Current liabilities	1,802	1,881
Noncurrent liabilities	5,606	4,946
Total liabilities	7,408	6,827
Deferred inflows	17	
Net position	$ 13,427	$ 12,151

The University continues to maintain and protect its strong financial foundation. This financial health, as reflected in the University’s net position at June 30, 2017 and 2016, 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 $2.7 billion and $2.5 billion at June 30, 2017 and 2016, respectively. Cash, cash equivalents and investments for operating activities totaled $1.4 billion at June 30, 2017, which represents approximately two months of total expenses excluding depreciation.

Deferred outflows represent the consumption of net assets attributable to a future period and are primarily associated with the University's obligations for postemployment benefits, as well as, debt and derivative activity, and Metro Health's defined benefit pension plan. Deferred outflows totaled $349 million and $30 million at June 30, 2017 and 2016, respectively.

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 $1.9 billion at June 30, 2017 and 2016, respectively.

Deferred inflows represent the acquisition of net assets attributable to a future period and are associated with Metro Health's defined benefit pension plan. Deferred inflows totaled $17 million at June 30, 2017.

Endowment, Life Income and Other Investments

The composition of the University's endowment, life income and other investments at June 30, 2017 and 2016 is summarized as follows:

	2017 (in millions)	**2016**
Endowment investments	$ 10,936	$ 9,743
Life income investments	132	111
Noncurrent portion of insurance and benefits obligations investments	205	192
Other	50	63
	$ 11,323	$ 10,109

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 10,500 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 entities that benefit from the endowment fund. The annual distribution rate is 4.5 percent of the one-quarter lagged seven year moving average fair value of University Endowment Fund shares. This spending rule is one element of an ongoing financial management strategy that has allowed the University to effectively weather challenging economic environments 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 $325 million and withdrawals from funds functioning as endowment totaled $7 million in 2017. Total spending rate distributions combined with withdrawals from funds functioning as endowment averaged 4.2 percent of the current year average fair value of the University Endowment Fund for 2017. 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 $636 million in 2017. Capital asset additions primarily represent renovation and new construction of 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 $396 million, as well as debt proceeds of $222 million and state capital appropriations of $18 million. Construction in progress, which totaled $476 million at June 30, 2017, includes important projects for research, instruction, patient care and athletics.

Projects completed in 2017 include significant renovation and new construction of academic and research buildings for business, engineering and natural sciences.

The Ross School of Business completed a comprehensive renovation of Kresge Hall, formerly the Kresge Business Administration Library, and construction of a new academic building to replace the Computer and Executive Education Building, which adds classrooms, study space, and faculty research and office space, as well as space for student life functions, financial aid, admissions and onsite recruiting. In total, this project represents 75,000 gross square feet of renovation and 104,000 gross square feet of new construction. Exterior building finishes were also 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.

The George Granger Brown Memorial Laboratories building, which was originally constructed in 1958, houses the chemical, civil, materials sciences and mechanical engineering departments within the College of Engineering. Renovation of this 220,000 gross square feet building included upgrades to the building's fire detection, alarm and emergency power systems. In addition, infrastructure improvements throughout the building included heating, ventilation, air conditioning, electrical, plumbing, roof, windows and interior finishes. This project also created 25,000 gross square feet of state-of-the-art academic and instructional spaces.

The Science Building on the University's Dearborn campus was originally constructed in 1959. Renovation of this 80,000 gross square foot building provides updated laboratory and classroom space for the Department of Natural Sciences. This project also incorporates an addition of 20,000 gross square feet 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 was also upgraded. The renewed facility will help transform science education and facilitate closer academic-industry and student-industry collaboration as well as facilitate collaboration with the College of Engineering in the emerging nano-science area.

Construction in progress at June 30, 2017 includes significant projects for instruction, research, international studies and athletics.

A Biological Science Building of 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 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 summer 2018.

An extensive renovation of Weiser Hall, formerly the Dennison Building which was originally constructed in 1963, is underway. Renovation of 106,000 gross square feet vacated by the relocation of the Department of Astronomy to West Hall and the repurposing of classrooms will create spaces that facilitate faculty collaboration and enhance opportunities for graduate and undergraduate students. This project enables the relocation of the International Institute and its associated centers for international studies from the School of Social Work Building, along with other College of Literature, Science, and the Arts centers, institutes and units that have a primary focus on international engagement. In addition, 1,500 gross square feet of space will be added by enclosing an overhang area on the ground floor, and extending windows outward on the tenth floor. This project is scheduled to be completed in summer 2017.

The Athletics South Competition and Performance Project will add 280,000 gross square feet of space for men’s and women’s track and field, cross country, lacrosse, soccer and women’s rowing. This project includes construction of an indoor and outdoor track competition venue, a lacrosse stadium and an indoor rowing tank. The project also includes construction of a performance and team center with specialized spaces for each team and shared resources for all teams, with strength and conditioning, athletic medicine, meeting space and locker rooms. This new center enables consolidation of various team facilities now dispersed across the athletic campus. The facilities will also be available to student-athletes who already practice and compete in that area, as well as students who participate in the University's recreational sports programs. This project is scheduled to be completed in winter 2018.

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 December 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, 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 year ended June 30, 2017 is summarized as follows (in millions):

	Beginning Balance	Additions	Reductions	Ending Balance
Commercial paper	$ 160	$ 23	$ 22	$ 161
Bonds	2,025	550	420	2,155
Other	4		2	2
	$ 2,189	$ 573	$ 444	$ 2,318

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 2017, consistent with capital and debt financing plans, the University issued $465 million of fixed rate, tax-exempt, general revenue bonds with a net original issue premium of $85 million. Total bond proceeds of $550 million, together with amounts held by trustees under bond indenture of $12 million, were utilized to convert $12 million of commercial paper to long-term debt, refund existing bonds of $238 million, establish an escrow to advance refund existing bonds of $112 million and provide $200 million for capital projects and debt issuance costs.

The composition of the University's debt at June 30, 2017 and 2016 is summarized as follows:

	2017	2016
	(in millions)	
Variable rate:		
Commercial paper	$ 161	$ 160
Bonds	602	676
Fixed rate bonds	1,553	1,349
Other	2	4
	$ 2,318	$ 2,189

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 2.7 percent in 2017, 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 $66 million in 2017.

Obligations for Defined Benefit Pension Plan

Metro Health has a noncontributory, defined benefit pension plan, which covered substantially all of its employees prior to being frozen as of December 31, 2007. The plan generally provides benefits based on each employee's years of service and final average earnings, as defined. At June 30, 2017 and 2016, the net pension liability totaled $3 million and $29 million, respectively, with the decline in the current year driven primarily by an increase in the investment rate of return assumption due to a change in the plan's asset allocation strategy.

Obligations for Postemployment Benefits

During 2017, the University adopted GASB 75, which establishes new actuarial methods and discount rate standards for the measurement and recognition of the cost of postemployment benefits during the periods when employees render their services, superseding the requirements of GASB Statement No. 45. Adoption of this statement resulted in an increase in the reported liability for postemployment benefits obligations and a decrease in unrestricted net position of $930 million, as reflected in the comparative balances presented at June 30, 2016.

Using current actuarial assumptions, and presuming a continuation of the current level of benefits, the University's obligations for postemployment benefits totaled $3.2 billion and $2.8 billion at June 30, 2017 and 2016, respectively. The increase in the reported liability at June 30, 2017 was driven primarily by a decline in the discount rate used in developing the valuation, which under GASB 75, is now based on the Bond Buyer 20-year General Obligation Municipal Bond Index. 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 $674 million and $616 million at June 30, 2017 and 2016, respectively.

By implementing a series of health benefit initiatives over the past 12 years, the University has favorably impacted its total liability for postemployment benefits by $1.5 billion at June 30, 2017. These initiatives have included cost sharing changes, elimination of Medicare Part B reimbursements for certain retirees and the adjustment of retirement eligibility criteria.

Net Position

Net position represents the residual interest in the University’s assets and deferred outflows after liabilities and deferred inflows are deducted. The composition of the University's net position at June 30, 2017 and 2016 is summarized as follows:

	2017	2016
	(in millions)	
Net investment in capital assets	$ 3,735	$ 3,715
Restricted:		
Nonexpendable:		
Permanent endowment corpus	1,967	1,816
Expendable:		
Net appreciation of permanent endowments	1,829	1,519
Funds functioning as endowment	2,126	1,942
Restricted for operations and other	699	669
Unrestricted	3,071	2,490
	$ 13,427	$ 12,151

Net investment in capital assets represents the University's capital assets net of accumulated depreciation, outstanding principal balances of debt and capital lease liabilities, unexpended bond proceeds and deferred outflows and inflows associated with the acquisition, construction or improvement of those assets.

Restricted nonexpendable net position represents the historical value (corpus) of gifts to the University's permanent endowment funds. 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 $4.7 billion at June 30, 2017, as compared to $4.1 billion at June 30, 2016, with the current year increase driven primarily by an increase in net appreciation of permanent endowments resulting from investment income.

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, 2017 totaled $3.1 billion and included funds functioning as endowment of $4.9 billion offset by unfunded obligations for postemployment benefits of $2.9 billion. Unrestricted net position at June 30, 2016 totaled $2.5 billion and included funds functioning as endowment of $4.3 billion offset by unfunded obligations for postemployment benefits of $2.8 billion. Unrestricted net position also includes other net resources which totaled $1.1 billion and $1.0 billion at June 30, 2017 and 2016, 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. The University's revenues, expenses and changes in net position for the two years ended June 30, 2017 is summarized as follows:

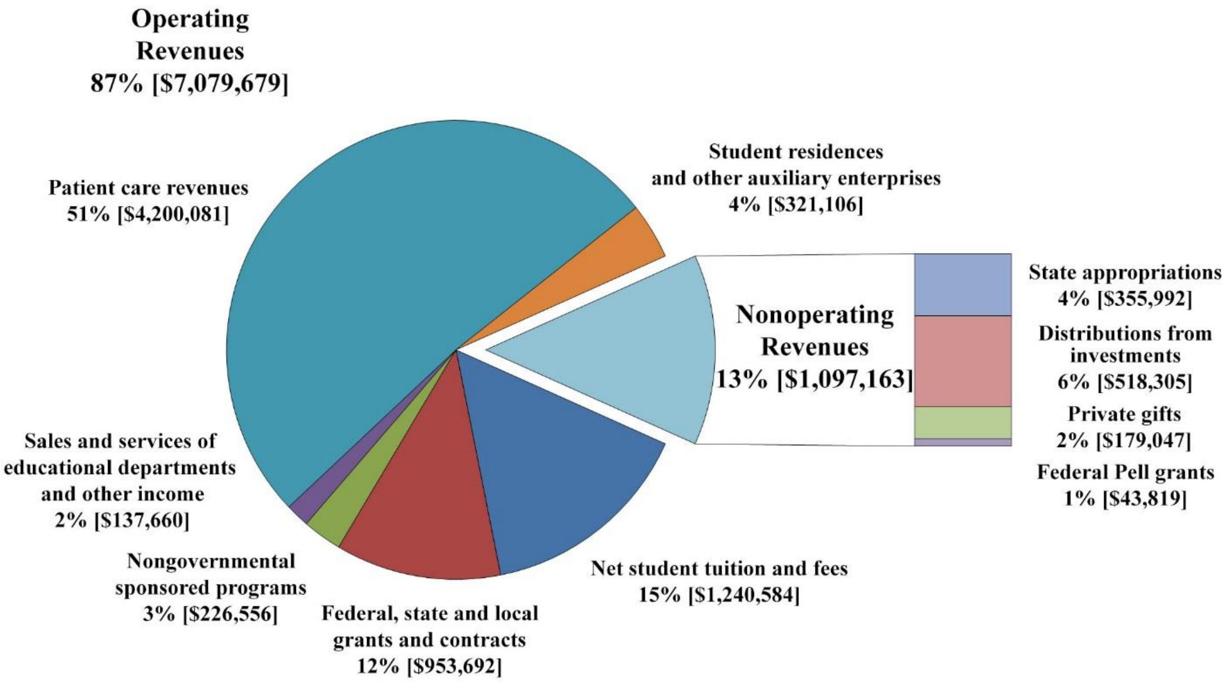
	2017	2016
	(in millions)	
Operating revenues:		
Net student tuition and fees	$ 1,240.6	$ 1,161.7
Sponsored programs	1,180.2	1,107.1
Patient care revenues, net	4,200.1	3,587.3
Other	458.8	421.9
	7,079.7	6,278.0
Operating expenses	7,910.0	7,152.8
Operating loss	(830.3)	(874.8)
Nonoperating and other revenues (expenses):		
State educational appropriations	356.0	345.8
Federal Pell grants	43.8	43.3
Private gifts for operating activities	179.0	167.2
Net investment income (loss)	1,415.2	(129.7)
Interest expense, net	(73.1)	(55.6)
Federal subsidies for interest on Build America Bonds	7.5	7.6
State capital appropriations	18.0	47.6
Endowment and capital gifts and grants	183.0	163.0
Other	(23.2)	(9.0)
Nonoperating and other revenues, net	2,106.2	580.2
Increase (decrease) in net position	1,275.9	(294.6)
Net position, beginning of year	13,001.2	13,295.8
Affiliation with Metro Health and adoption of GASB 75	(850.0)	
Net position, beginning of year, as restated	12,151.2	13,295.8
Net position, end of year	$ 13,427.1	$ 13,001.2

The impact of the Metro Health affiliation and the adoption of GASB 75 has been reflected as of the beginning of the earliest period presented in the financial statements, or July 1, 2016. Therefore, the statement of revenues, expenses and changes in net position presented above for the year ended June 30, 2016 does not reflect these items. During 2016, Metro Health reported total operating revenues of $374 million and total operating expenses of $357 million.

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.

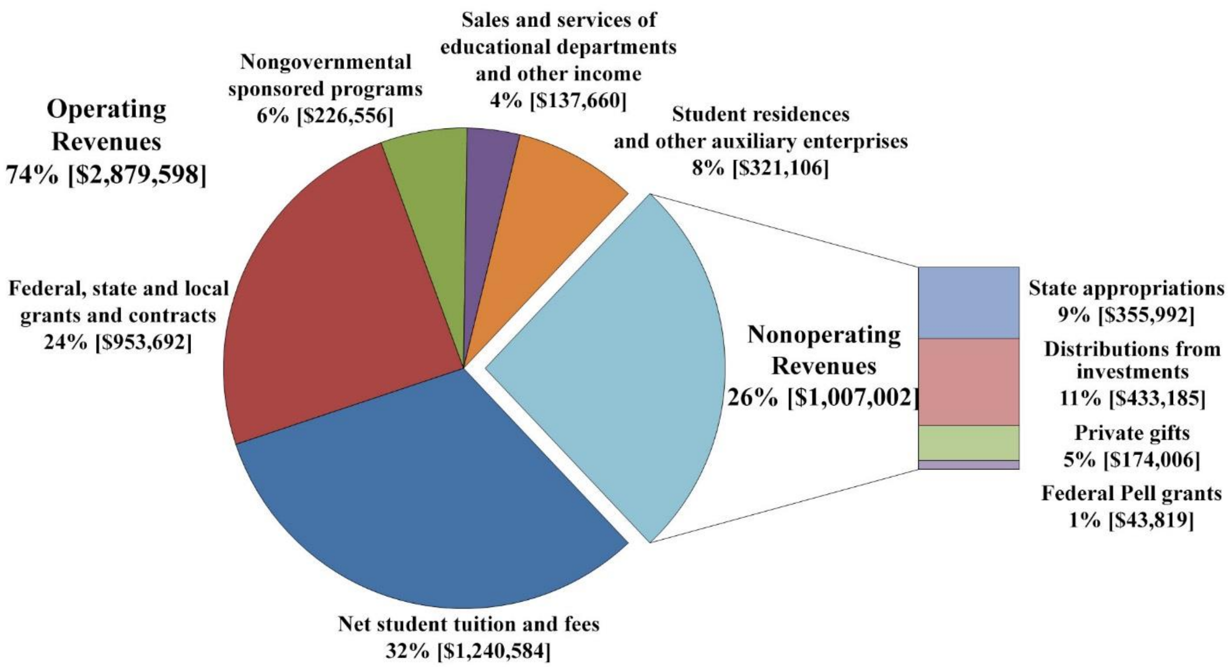
The following is a graphic illustration of revenues by source, both operating and nonoperating, which are used to fund the University's operating activities for the year ended June 30, 2017 (amounts are presented in thousands of dollars). Certain recurring sources of the University's revenues are considered nonoperating, as defined by GASB, such as state appropriations, distributions from investments, private gifts and federal Pell grants.

2017 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, 2017 (amounts are presented in thousands of dollars).

2017 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 totaled $1.6 billion in 2017.

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 2017, the University's state educational appropriations totaled $356 million.

For the year ended June 30, 2017, net student tuition and fees revenue consisted of the following components (in millions):

Student tuition and fees	$ 1,616.6
Less scholarship allowances	376.0
	$ 1,240.6

Tuition rate increases in 2017 were 3.9 percent for resident undergraduate students, 4.4 percent for nonresident undergraduate students and 3.9 percent for most graduate students on the Ann Arbor campus, with a 4.1 percent tuition rate increase for most undergraduate students on both the Dearborn and Flint campuses. During 2017, the University experienced moderate growth in the number of students, as well as 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 endowment purposes totaled $179 million in 2017.

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 totaled $1.2 billion in 2017.

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. The distribution of gross charge activity by primary payer source for the year ended June 30, 2017 is summarized as follows:

Medicare	37%
Medicaid	17%
Blue Cross	29%
Other	17%

Patient care revenues totaled $4.2 billion in 2017 and reflect growth in patient volume, as well as an increase in revenue per patient case.

Net investment income totaled $1.4 billion in 2017. The investment environment in 2017 was favorable and all asset classes were positive for the year. The continued low interest rate environment and improving global economic activity helped lift expectations for corporate earnings growth across developed and emerging markets. Equity securities performance was particularly strong in the current year returning 25 percent, while private equity and natural resources led the alternative asset classes with returns of 17 percent. Other alternative investment classes include real estate and venture capital where returns ranged from 6 to 10 percent.

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 $18 million in 2017.

Gifts and grants for endowment and capital purposes continue to be a significant part of sustaining the University's excellence. In 2017, private gifts for permanent endowment purposes totaled $139 million and capital gifts and grants totaled $44 million. 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, Ross School of Business, College of Engineering and Intercollegiate Athletics.

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

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 63 percent of total expenses, as well as in the areas of energy, technology and ongoing maintenance of facilities and infrastructure.

The University's expenses for the year ended June 30, 2017 are summarized as follows (amounts in millions):

Operating:		
Compensation and benefits	$ 5,064.4	63%
Supplies and services	2,164.0	27
Depreciation	537.7	7
Scholarships and fellowships	143.9	2
	7,910.0	99
Nonoperating:		
Interest, net	65.6	1
	$ 7,975.6	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. Compensation and benefits totaled $5.1 billion in 2017, which included compensation of $3.9 billion and employee benefits of $1.2 billion. During 2017, 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.

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

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, and 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. New employees hired after December 31, 2012 will receive a maximum contribution of 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 the national health care debate continues, 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.

In 2017, the University continued to make progress toward improving the health and well-being of faculty and staff, with over 25,000 employees participating in MHealthy programs and services. These initiatives not only help to decrease health risks for faculty and staff, but also improve the overall workplace culture at the University. The impact of these initiatives can also be measured in an overall increase in employee satisfaction, as according to a University-wide random sample survey, 64 percent of faculty and staff agreed that the University’s health and well-being initiatives contribute to it being a great place to work.

Supplies and services expenses totaled $2.2 billion in 2017 and reflect the growth in patient care related expenses including higher costs of prescription drugs and infusion treatments, as well as costs associated with significant capital projects.

Depreciation expense totaled $538 million in 2017 and reflects 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 2017 include the renovation and an addition to the Ross School of Business, as well as the renovation of the Dearborn Science and Computer Information Science buildings and the George Granger Brown Memorial Laboratories.

In addition to their natural (object) classification, it is also informative to review operating expenses by function. The University's expenses by functional classification for the year ended June 30, 2017 are summarized as follows (amounts in millions):

Operating:		
Instruction	$ 1,099.8	14%
Research	803.5	10
Public service	187.8	2
Institutional and academic support	646.7	8
Auxiliary enterprises:		
Patient care	3,976.1	50
Other	198.1	2
Operations and maintenance of plant	316.4	4
Depreciation	537.7	7
Scholarships and fellowships	143.9	2
	7,910.0	99
Nonoperating:		
Interest, net	65.6	1
	$ 7,975.6	100%

Instruction expenses totaled $1.1 billion in 2017 and reflect the modest level of growth in the related revenue sources offset by cost containment efforts.

Research expenses totaled $804 million in 2017, driven by the strength of the University's research enterprise, in spite of continued pressure on federal funding 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 $1.5 billion in 2017.

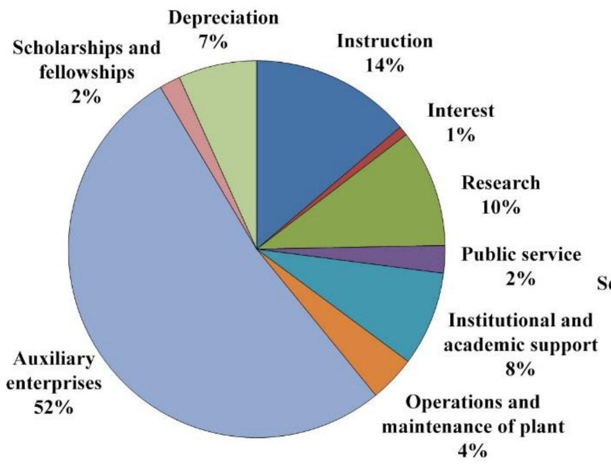
Patient care expenses totaled $4.0 billion in 2017 and reflect the impact of additional patient care volume, including costs of staffing, medical supplies and pharmaceuticals.

Scholarships and fellowships provided to students totaled $543 million in 2017. 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 year ended June 30, 2017 are summarized as follows (in millions):

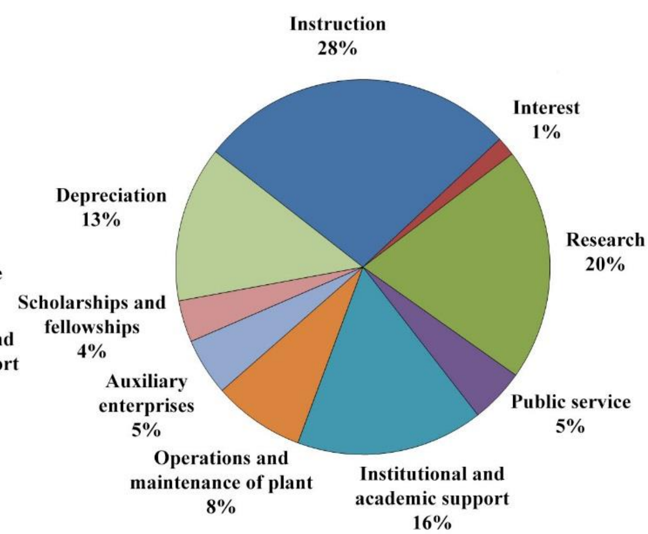
Paid directly to students	$ 143.9
Applied to tuition and fees	376.0
Applied to University Housing	22.7
	$ 542.6

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

2017 Expenses by Function



2017 Expenses by Function Excluding Expenses from 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. The University's cash flows for the years ended June 30, 2017 and 2016 are summarized as follows:

	2017	2016
	(in millions)	
Cash received from operations	$ 7,103.6	$ 6,330.7
Cash expended for operations	(7,277.3)	(6,496.5)
Net cash used in operating activities	(173.7)	(165.8)
Net cash provided by noncapital financing activities	715.5	679.0
Net cash used in capital and related financing activities	(497.9)	(449.3)
Net cash (used in) provided by investing activities	(278.4)	116.4
Net (decrease) increase in cash and cash equivalents	(234.5)	180.3
Cash and cash equivalents, beginning of year	285.8	105.5
Affiliation with Metro Health	53.8	
Cash and cash equivalents, beginning of year, as restated	339.6	105.5
Cash and cash equivalents, end of year	$ 105.1	$ 285.8

The impact of the Metro Health affiliation is reflected as of the beginning of the earliest period presented in the financial statements, or July 1, 2016. Therefore, the statement of cash flows presented above for the year ended June 30, 2016 does not reflect the impact of this affiliation.

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 May Affect the Future

The University continues to face significant financial challenges to its academic programs, stemming from the State's difficult economic environment. Given these circumstances, 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 2018 anticipates a 1.9 percent increase in state educational appropriations, a 2.9 percent tuition rate increase for Ann Arbor campus resident undergraduates and a 9.5 percent increase in centrally awarded financial aid. Nonresident undergraduate tuition rates will increase 4.5 percent, while most graduate and professional rates will increase 4.1 percent. Resident undergraduate tuition rates on the Dearborn and Flint campuses will increase 3.7 percent and 4.1 percent, respectively.

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. 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, athletics 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 $901 million at June 30, 2017. Funding for these projects is anticipated to include $797 million from internal sources, gifts, grants and future borrowings, $6 million from the State Building Authority and $98 million from the utilization of unexpended bond 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. While the University's health system 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 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. 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, 2017 (in thousands)
Assets and Deferred Outflows	
Current Assets:	
Cash and cash equivalents	$ 105,127
Investments for operating activities	1,265,208
Investments for capital activities	378,931
Investments for student loan activities	58,836
Accounts receivable, net	639,384
Current portion of notes and pledges receivable, net	76,148
Current portion of prepaid expenses and other assets	127,799
Cash collateral held by agent	44,130
Total Current Assets	2,695,563
Noncurrent Assets:	
Unexpended bond proceeds	98,455
Endowment, life income and other investments	11,322,610
Notes and pledges receivable, net	312,478
Prepaid expenses and other assets	28,740
Capital assets, net	6,045,442
Total Noncurrent Assets	17,807,725
Total Assets	20,503,288
Deferred Outflows	348,691
Total Assets and Deferred Outflows	$ 20,851,979
Liabilities, Deferred Inflows and Net Position	
Current Liabilities:	
Accounts payable	$ 328,672
Accrued compensation and other	442,749
Unearned revenue	283,551
Current portion of insurance and benefits reserves	97,799
Current portion of obligations for postemployment benefits	77,374
Commercial paper and current portion of bonds payable	237,243
Long-term bonds payable subject to remarketing, net	202,718
Collateral held for securities lending	44,130
Deposits of affiliates and others	87,811
Total Current Liabilities	1,802,047
Noncurrent Liabilities:	
Accrued compensation	43,904
Insurance and benefits reserves	116,236
Obligations for defined benefit pension plan	3,436
Obligations for postemployment benefits	3,120,953
Obligations under life income agreements	65,897
Government loan advances	88,401
Bonds payable	1,877,554
Deposits of affiliates and other	289,213
Total Noncurrent Liabilities	5,605,594
Total Liabilities	7,407,641
Deferred Inflows	17,281
Net Position:	
Net investment in capital assets	3,735,130
Restricted:	
Nonexpendable	1,966,541
Expendable	4,653,983
Unrestricted	3,071,403
Total Net Position	13,427,057
Total Liabilities, Deferred Inflows and Net Position	$ 20,851,979

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, 2017 (in thousands)
Operating Revenues	
Student tuition and fees	$ 1,616,575
Less scholarship allowances	375,991
Net student tuition and fees	1,240,584
Federal grants and contracts	942,287
State and local grants and contracts	11,405
Nongovernmental sponsored programs	226,556
Sales and services of educational departments	135,212
Auxiliary enterprises:	
Patient care revenues (net of provision for bad debts of $95,214)	4,200,081
Student residence fees (net of scholarship allowances of $22,678)	112,478
Other revenues	208,628
Student loan interest income and fees	2,448
Total Operating Revenues	7,079,679
Operating Expenses	
Compensation and benefits	5,064,422
Supplies and services	2,164,018
Depreciation	537,670
Scholarships and fellowships	143,932
Total Operating Expenses	7,910,042
Operating loss	(830,363)
Nonoperating Revenues (Expenses)	
State educational appropriations	355,992
Federal Pell grants	43,819
Private gifts for other than capital and endowment purposes	179,047
Net investment income	1,415,232
Interest expense, net	(73,150)
Federal subsidies for interest on Build America Bonds	7,506
Total Nonoperating Revenues, Net	1,928,446
Income before other revenues (expenses)	1,098,083
Other Revenues (Expenses)	
State capital appropriations	17,965
Capital gifts and grants	43,817
Private gifts for permanent endowment purposes	139,170
Other	(23,150)
Total Other Revenues, Net	177,802
Increase in net position	1,275,885
Net Position, Beginning of Year	13,001,255
Affiliation with Metro Health and Adoption of GASB 75	(850,083)
Net Position, Beginning of Year, as Restated	12,151,172
Net Position, End of Year	$ 13,427,057

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

UNIVERSITY OF MICHIGAN

Consolidated Statement of Cash Flows

	Year Ended June 30, 2017 (in thousands)
Cash Flows From Operating Activities	
Student tuition and fees	$ 1,242,227
Federal, state and local grants and contracts	945,781
Nongovernmental sponsored programs	240,657
Sales and services of educational departments and other	338,496
Patient care revenues	4,200,681
Student residence fees	112,623
Payments to employees	(3,881,649)
Payments for benefits	(1,060,665)
Payments to suppliers	(2,171,333)
Payments for scholarships and fellowships	(143,932)
Student loans issued	(19,675)
Student loans collected	20,730
Student loan interest and fees collected	2,448
Net Cash Used in Operating Activities	(173,611)
Cash Flows From Noncapital Financing Activities	
State educational appropriations	354,143
Federal Pell grants	43,819
Private gifts and other receipts	299,984
Student direct lending receipts	297,406
Student direct lending disbursements	(291,964)
Amounts received for annuity and life income funds	21,243
Amounts paid to annuitants and life beneficiaries and related expenses	(9,142)
Net Cash Provided by Noncapital Financing Activities	715,489
Cash Flows From Capital and Related Financing Activities	
State capital appropriations	40,676
Private gifts and other receipts	45,674
Proceeds from issuance of capital debt	573,439
Principal payments on capital debt	(428,828)
Interest payments on capital debt	(88,383)
Federal subsidies for Build America Bonds interest	7,462
Payments for bond refunding and related costs	(1,447)
Purchases of capital assets	(648,245)
Proceeds from sales of capital assets	1,692
Net Cash Used in Capital and Related Financing Activities	(497,960)
Cash Flows From Investing Activities	
Interest and dividends on investments, net	48,375
Proceeds from sales and maturities of investments	5,389,209
Purchases of investments	(5,718,627)
Unexpended capital debt proceeds	(98,455)
Net increase in cash equivalents from noncurrent investments	60,398
Net increase in deposits of affiliates and other	40,714
Net Cash Used in Investing Activities	(278,386)
Net decrease in cash and cash equivalents	(234,468)
Cash and Cash Equivalents, Beginning of Year	285,838
Affiliation with Metro Health	53,757
Cash and Cash Equivalents, Beginning of Year, as Restated	339,595
Cash and Cash Equivalents, End of Year	$ 105,127

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

Consolidated Statement of Cash Flows--Continued

	Year Ended June 30, 2017 (in thousands)
Reconciliation of operating loss to net cash used in operating activities:	
Operating loss	$ (830,363)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation expense	537,670
Changes in assets and liabilities:	
Accounts receivable, net	(11,427)
Prepaid expenses and other assets	(10,662)
Accounts payable	(4,103)
Accrued compensation and other	21,952
Unearned revenue	15,716
Insurance and benefits reserves	10,832
Obligations for defined benefit pension plan	(25,742)
Obligations for postemployment benefits	427,401
Changes in deferred outflows	(322,166)
Changes in deferred inflows	17,281
Net cash used in operating activities	$ (173,611)

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, Michigan Health Corporation (a wholly-owned corporation created for joint venture and managed care initiatives), UM Health (a wholly-owned corporation created to hold and develop the University's statewide network of hospitals, hospital joint ventures and other hospital affiliations) 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.

On December 15, 2016, the University completed an affiliation with Metropolitan Health Corporation ("Metro Health"), a community health care provider in west Michigan, pursuant to which UM Health became the sole corporate member of Metro Health. In accordance with GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, this affiliation is included in the financial statements as if it occurred at the beginning of the earliest period presented. The University recognized, measured and combined the assets, deferred outflows, liabilities and net position of Metro Health based upon GASB accounting principles applied at July 1, 2016.

During 2017, the University adopted GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, ("GASB 75"). This statement supersedes GASB Statement No. 45 and establishes new requirements for calculating and reporting the University's postemployment benefits. The adoption of GASB 75 has been reflected as of the beginning of the earliest period presented in the financial statements, resulting in an increase in obligations for postemployment benefits and a decrease in unrestricted net position of $930,343,000 at July 1, 2016.

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

Net position as of July 1, 2016 was restated for the effects of the University's affiliation with Metro Health and the adoption of GASB 75 as follows (in millions):

	June 30, 2016 As Previously Reported*	Metro Health Affiliation	GASB 75 Adoption	July 1, 2016 As Restated
Current assets	$ 2,445	$ 100		$ 2,545
Noncurrent assets:				
Endowment, life income and other investments	10,046	63		10,109
Capital assets, net	5,709	239		5,948
Other	337	9		346
Total assets	18,537	411		18,948
Deferred outflows	30			30
Total assets and deferred outflows	18,567	411		18,978
Current liabilities	1,771	113	$ (3)	1,881
Noncurrent liabilities	3,795	218	933	4,946
Total liabilities	5,566	331	930	6,827
Net position	$ 13,001	$ 80	$ (930)	$ 12,151

*Certain balances as of June 30, 2016 have been reclassified to conform with current year presentations.

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, outstanding principal balances of debt and capital lease liabilities, unexpended bond proceeds and deferred outflows and inflows associated with 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.

- 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.

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

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.

GASB Statement No. 72, *Fair Value Measurement and Application,* ("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 to determine the fair value of nonmarketable investments if the NAV is calculated in a manner consistent with the Financial Accounting Standards Board's measurement principles for investment companies. 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.

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

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, 2017. 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.

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.

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

Capital assets are recorded at cost or, if donated, at acquisition 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.

Deferred outflows represent the consumption of net assets attributable to a future period and are primarily associated with the University's obligations for postemployment benefits, as well as, debt and derivative activity, and Metro Health's defined benefit pension plan.

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.

Deferred inflows represent the acquisition of net assets attributable to a future period and are associated with Metro Health's defined benefit pension plan.

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 $1,828,744,000 at June 30, 2017, 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.

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

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's health system, which includes the University of Michigan Hospitals, Metro Health, the University of Michigan Medical Group and 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.

Patient care services are provided to patients who meet certain criteria under the University's charity care policies 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 $52,986,000 in 2017.

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 exchange transactions such as payments received for providing services and payments made for services or goods received. Nearly all of the University's expenses are from exchange transactions.

Certain significant revenue streams relied upon for operations 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.

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 primarily 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 entities that benefit from the endowment fund. The annual distribution rate is 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 $105,127,000 at June 30, 2017, 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 $61,583,000 at June 30, 2017. 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. At June 30, 2017, Level 1 securities, which primarily consist of money market funds and U.S. government securities, totaled $6,845,000, while Level 2 securities, which primarily consist of U.S. agencies, totaled $59,900,000.

Investments: At June 30, 2017, the University's investments, which are held by the University or its agents in the University's name, are summarized as follows (in thousands):

Cash equivalents, noncurrent	$ 102,550
Equity securities	1,364,719
Fixed income securities	2,181,020
Commingled funds	3,255,747
Nonmarketable alternative investments	6,112,495
Other investments	9,054
	$ 13,025,585

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, 2017, the fair value of the University's investments based on the inputs used to value them is summarized as follows (in thousands):

	Level 1	Level 2	Level 3	NAV	Total Fair Value
Cash equivalents, noncurrent	$ 102,550	-	-	-	$ 102,550
Equity securities:					
Domestic	446,823		$ 28,358		475,181
Foreign	888,965		573		889,538
	1,335,788	-	28,931	-	1,364,719
Fixed income securities:					
U.S. Treasury	1,020,420				1,020,420
U.S. government agency		$ 301,634			301,634
Corporate and other		854,885	4,081		858,966
	1,020,420	1,156,519	4,081	-	2,181,020
Commingled funds:					
Absolute return				$ 2,036,001	2,036,001
Domestic equities	17,206			274,829	292,035
Global equities	8,896			862,070	870,966
U.S. fixed income	10,938			41,332	52,270
Other	4,475				4,475
	41,515	-	-	3,214,232	3,255,747
Nonmarketable alternative investments:					
Venture capital				1,430,158	1,430,158
Absolute return				1,299,022	1,299,022
Private equity			207,078	1,271,632	1,478,710
Real estate			8,033	968,849	976,882
Natural resources			176,294	751,429	927,723
	-	-	391,405	5,721,090	6,112,495
Other investments	1,302	(4,036)	11,788	-	9,054
	$ 2,501,575	$ 1,152,483	$ 436,205	$ 8,935,322	$ 13,025,585

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 debt investments with select venture funded University faculty start-ups. Nonmarketable alternative investments categorized as Level 3 primarily include direct investments which are 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 5.0 years at June 30, 2017. 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, 2017, 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, 2017, along with credit quality and effective duration measures, is summarized as follows:

	U.S. Government	Investment Grade	Non-Investment Grade (in thousands)	Not Rated	Total	Duration (in years)
U.S. Treasury	$ 791,194				$ 791,194	6.2
U.S. Treasury inflation protected	229,226				229,226	2.7
U.S. government agency	301,634				301,634	0.5
Mortgage backed		$ 64,229	$ 7,143	$ 5,159	76,531	1.0
Asset backed		71,441	650	126	72,217	0.7
Corporate and other		695,333	6,975	7,910	710,218	7.2
	$ 1,322,054	$ 831,003	$ 14,768	$ 13,195	$ 2,181,020	5.0

Of the University’s fixed income securities, 99 percent were rated investment grade or better at June 30, 2017, and 69 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, 2017.

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, 2017, 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, 2017 is summarized as follows (amounts in thousands):

	Fair Value	Remaining Life	Outstanding Commitments	Redemption Terms	Redemption Notice
Commingled funds	$ 3,255,747	N/ A		Daily, monthly, quarterly, and annually, with varying notice periods	Lock-up provisions range from none to 3 years
Nonmarketable alternative investments	$ 6,112,495	1-12 years	$ 4,766,977	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, 2017, approximately 78 percent are redeemable within one year, with 61 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 14.

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 the value of the outstanding forward foreign exchange contracts, totaled $1,694,128,000 or 13 percent of total investments at June 30, 2017, and are summarized as follows (in thousands):

Euro	$ 954,456
British pound sterling	230,211
Japanese yen	230,547
Canadian dollar	69,764
Swedish krona	52,440
Swiss franc	45,640
Other	111,070
	$ 1,694,128

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 $90,638,000 in securities loans outstanding at June 30, 2017. 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, 2017, collateral of $95,679,000 (106 percent of securities on loan) includes invested cash of $44,130,000 and U.S. government securities of $51,549,000.

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, 2017 is summarized as follows (in thousands):

Patient care	$ 633,727
Sponsored programs	143,958
State appropriations, educational and capital	65,933
Student accounts	29,544
Other	33,602
	906,764
Less allowance for uncollectible accounts receivable:	
Patient care	258,847
All other	8,533
	$ 639,384

Note 4--Notes and Pledges Receivable

The composition of notes and pledges receivable at June 30, 2017 is summarized as follows (in thousands):

Notes:	
Federal student loan programs	$ 88,911
University student loan funds	17,563
Other	1,120
	107,594
Less allowance for uncollectible notes	3,100
Total notes receivable, net	104,494
Gift pledges:	
Capital	177,043
Operations	121,047
	298,090
Less:	
Allowance for uncollectible pledges	10,064
Unamortized discount to present value	3,894
Total pledges receivable, net	284,132
Total notes and pledges receivable, net	388,626
Less current portion	76,148
	$ 312,478

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, 2017 are expected to be received in the following years ended June 30 (in thousands):

2018	$ 61,113
2019	46,737
2020	37,136
2021	36,942
2022	22,200
2023 and after	93,962
	$ 298,090

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 $185,551,000 at June 30, 2017, are not recognized as assets in the accompanying financial statements. 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 year ended June 30, 2017 is summarized as follows (in thousands):

	Beginning Balance	Additions	Retirements	Ending Balance
Land	$ 124,207	$ 2,410		$ 126,617
Land improvements	125,953	12,152	$ 124	137,981
Infrastructure	255,921	2,528		258,449
Buildings	8,206,614	430,132	18,369	8,618,377
Construction in progress	456,391	19,733		476,124
Property held for future use	24,502	(24,502)		-
Equipment	2,068,851	167,252	185,255	2,050,848
Library materials	593,768	26,432		620,200
	11,856,207	636,137	203,748	12,288,596
Less accumulated depreciation	5,907,820	537,670	202,336	6,243,154
	$ 5,948,387	$ 98,467	$ 1,412	$ 6,045,442

The increase in construction in progress of $19,733,000 in 2017 represents the amount of capital expenditures for new projects of $563,683,000 net of assets placed in service of $543,950,000.

Note 6--Long-term Debt

Long-term debt at June 30, 2017 is summarized as follows (in thousands):

Commercial Paper:	
Tax-exempt, variable rate (.92%)*	$ 157,160
Taxable, variable rate (1.03%)*	3,885
General Revenue Bonds:	
Series 2017A, 4.00% to 5.00% through 2047	464,750
unamortized premium	84,172
Series 2015, 4.00% to 5.00% through 2046	304,615
unamortized premium	50,686
Series 2014A, 4.25% to 5.00% through 2044	77,825
Series 2014B, 1.771% to 3.516% through 2024	6,625
unamortized premium	6,963
Series 2013A, 2.50% to 5.00% through 2029	46,385
unamortized premium	1,885
Series 2012A, variable rate (.85%)* through 2036	50,000
Series 2012B, variable rate (.70%)* through 2042	65,000
Series 2012D-1, variable rate (.68%)* through 2025 with partial swap to fixed through 2025	63,635
Series 2012D-2, variable rate (.88%)* through 2030 with partial swap to fixed through 2026 and variable rate 2027 through 2030	66,990
Series 2012E**, variable rate (1.34%)* through 2033	95,500
Series 2010A, taxable-Build America Bonds, 4.926% to 5.593% through 2040	163,110
Series 2010C, 3.75% to 5.00% through 2027	61,570
unamortized premium	4,434
Series 2010D, taxable-Build America Bonds, 3.176% to 5.333% through 2041	173,560
Series 2009A, 3.00% to 5.00% through 2019	12,555
unamortized premium	2,991
Series 2009B, variable rate (.87%)* through 2039	118,710
Series 2009D, taxable-Build America Bonds, 5.155% to 6.172% through 2030	89,815
Series 2008A, variable rate (.75%)* through 2038	57,085
Series 2008B, variable rate (.89%)* through 2028 with swap to fixed through 2026	77,185
Series 2005A, 5.00% through 2018	1,065
unamortized premium	17
Series 2002, variable rate (.91%)* through 2018 with swap to fixed through 2018	7,595
Other	1,747
	2,317,515
Less:	
Commercial paper and current portion of bonds payable	237,243
Long-term bonds payable subject to remarketing, net	202,718
	$ 1,877,554

* Denotes variable rate at June 30, 2017
** 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, 2017 is summarized as follows (in thousands):

Variable rate bonds payable subject to remarketing	$ 506,200
Less:	
Current principal maturities	21,615
Long-term liquidity agreements:	
Unsecured line of credit	150,000
Standby bond purchase agreements	131,867
Long-term bonds payable subject to remarketing, net	$ 202,718

The University's available line of credit and standby bond purchase agreements were entirely unused at June 30, 2017.

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.

Long-term debt activity for the year ended June 30, 2017 is summarized as follows (in thousands):

	Beginning Balance	Additions	Reductions	Ending Balance
Commercial paper	$ 159,970	$ 23,420	$ 22,345	$ 161,045
Bonds	2,025,251	550,019	420,547	2,154,723
Other	4,175		2,428	1,747
	$ 2,189,396	$ 573,439	$ 445,320	$ 2,317,515

Note 6--Long-term Debt--Continued

The University maintains a combination of variable and fixed rate debt supported by general revenues, with effective interest rates that averaged 2.7 percent in 2017, 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 2017, the University issued $464,750,000 of fixed rate General Revenue Bonds Series 2017A with a net original issue premium of $85,269,000. Total bond proceeds of $550,019,000 together with amounts held by trustees under bond indenture of $12,019,000 were utilized to convert $12,285,000 of commercial paper to long-term debt, refund $237,540,000 of existing bonds, and establish an escrow of $111,752,000 to advance refund existing bonds, as well as provide $199,014,000 for capital projects and $1,447,000 for debt issuance costs.

Bond proceeds of $162,376,000 along with amounts held by trustees under bond indenture of $12,019,000 were used to refund Metro Health's Series 2005A Revenue Bonds of $122,945,000 and Series 2012 Variable Rate Demand Revenue and Revenue Refunding Bonds of $51,450,000, which had average interest rates of 5.99 percent and 3.08 percent, respectively. As a result of these refundings, the University reduced its aggregate debt service payments over the next 24 years by $68,469,000, resulting in an economic gain with present value savings of $39,171,000.

Bond proceeds of $63,145,000 were used to refund a portion of General Revenue Bonds Series 2012C which had an average interest rate of 5.00 percent and a final bullet maturity due April 1, 2017. As a result of the refunding, the University's aggregate debt service payments increased over the next 15 years by $11,125,000, resulting in an economic gain with present value savings of $600,000.

The University established an escrow with bond proceeds of $111,752,000 to advance refund $35,440,000 of General Revenue Bonds Series 2009A and $65,915,000 of General Revenue Bonds Series 2010C which had average interest rates of 4.51 percent and 4.64 percent, respectively. These bonds are considered legally defeased as funds were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the refunded bonds. As a result of these advance refundings, the University reduced its aggregate debt service payments over the next 12 years by $9,490,000, resulting in an economic gain with present value savings of $8,078,000.

Note 6--Long-term Debt--Continued

During 2017, the University deferred $10,397,000 in connection with its refunding activity, which will be amortized into interest expense over the remaining life of the refunded bonds. At June 30, 2017, a total of $17,011,000 has been deferred in connection with the University's refunding activity.

Debt obligations are generally callable by the University and mature at various dates through fiscal 2047. Principal maturities, including interest on debt obligations, based on scheduled bond maturities for the next five years and in subsequent five-year periods are as follows (in thousands):

	Principal	Interest*	Total
2018	$ 227,778	$ 72,567	$ 300,345
2019	64,968	71,006	135,974
2020	66,596	69,236	135,832
2021	70,190	67,241	137,431
2022	73,325	65,300	138,625
2023-2027	411,050	286,402	697,452
2028-2032	419,130	200,904	620,034
2033-2037	437,005	126,492	563,497
2038-2042	304,820	53,563	358,383
2043-2047	91,505	12,285	103,790
Total payments	2,166,367	$ 1,024,996	$ 3,191,363
Plus unamortized premiums	151,148		
	$ 2,317,515		

* Interest on variable rate debt is estimated based on rates in effect at June 30, 2017; 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 2018 would increase to $288,841,000, total principal payments due in 2019 would increase to $123,517,000, total principal payments due in 2020 would increase to $105,590,000 and total principal payments due in 2021 would increase to $86,384,000. Accordingly, principal payments due in subsequent years would be reduced to $66,725,000 in 2022; $373,480,000 in 2023 through 2027; $410,585,000 in 2028 through 2032; $376,455,000 in 2033 through 2037; $243,285,000 in 2038 through 2042; and $91,505,000 in 2043 through 2047. 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, 2017 are summarized as follows (in thousands):

	Notional Amount	Fair Value
Investment Derivative Instruments:		
Investment portfolios:		
Futures	$ 242,854	$ (6,371)
Foreign currency forwards:		
Chinese yuan	332,080	(8,633)
New Zealand dollar	51,891	(4,891)
South African rand	71,852	3,453
Euro	144,951	3,190
Czech koruna	27,072	(2,103)
Swedish krona	82,727	(2,019)
All other currencies	1,057,651	2,066
	1,768,224	(8,937)
Other	2,089,063	12,723
	$ 4,100,141	$ (2,585)
Floating-to-fixed interest rate swap on debt	$ 7,595	$ (186)
Effective Cash Flow Hedges:		
Floating-to-fixed interest rate swaps on debt	$ 166,660	$ (19,312)

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.

Note 7--Derivative Instruments--Continued

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.

At June 30, 2017, the fair value of floating-to-fixed interest rate swaps associated with the University's variable rate debt is a liability of $19,498,000, respectively, and is included in the statement of net position as a component of Deposits of affiliates and other. The deferred outflows for the fair value of swaps deemed effective cash flow hedges totaled $5,181,000, at June 30, 2017.

The change in fair value of derivative instruments, which includes realized gains and losses on positions closed, for the year ended June 30, 2017 is summarized as follows (in thousands):

Investment Derivative Instruments:	
Investment portfolios:	
Futures	$ 27,627
Foreign currency forwards	57,408
Other	(21,006)
	$ 64,029
Floating-to-fixed interest rate swap on debt	$ 462
Effective Cash Flow Hedges:	
Floating-to-fixed interest rate swaps on debt	$ 10,626

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 $60,470,000 at June 30, 2017, 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, 2017 and has a fair value of ($5,448,000).

The floating-to-fixed interest rate swap associated with the Series 2005B Hospital Revenue Bonds has a notional amount of $42,685,000 at June 30, 2017. 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 swap terminates 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, 2017 and has a fair value of ($3,564,000).

The floating-to-fixed interest rate swap associated with the Series 2002 General Revenue Bonds has a notional amount of $7,595,000 at June 30, 2017, 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 3.538 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 1, 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, 2017 and has a fair value of ($186,000).

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 June 30, 2017. 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, 2017 and has a fair value of ($8,663,000).

The floating-to-fixed interest rate swap associated with the Series 1998A-1 Medical Service Plan Revenue Refunding Bonds has a notional amount of $18,835,000 at June 30, 2017. 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 a portion of the underlying bonds in December 2021. 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, 2017 and has a fair value of ($1,637,000).

Using rates in effect at June 30, 2017, 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 (in thousands):

	Variable Rate Bonds		Swap Payments,	Total
	Principal	Interest	Net	Payments
2018	$ 14,020	$ 1,660	$ 4,633	$ 20,313
2019	13,770	1,543	4,256	19,569
2020	14,365	1,428	3,882	19,675
2021	15,000	1,303	3,476	19,779
2022	15,645	1,178	3,067	19,890
2023-2027	108,050	3,135	4,466	115,651
2028-2030	26,960	236		27,196
	$ 207,810	$ 10,483	$ 23,780	$ 242,073

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 a portion 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. At June 30, 2017, the University is not exposed to credit risk as 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 $21,099,000 at June 30, 2017 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 5 percent.

Changes in the total reported liability for insurance and benefits obligations for the year ended June 30, 2017 are summarized as follows (in thousands):

Balance, beginning of year	$ 203,203
Claims incurred and changes in estimates	628,681
Claim payments	(617,849)
Balance, end of year	214,035
Less current portion	97,799
	$ 116,236

Note 9--Pension Plan

Metro Health has a noncontributory, single employer defined benefit pension plan, which covered substantially all employees prior to being frozen as of December 31, 2007. The plan generally provides benefits based on each employee's years of service and final average earnings, as defined, and does not provide any automatic or ad-hoc cost of living adjustments. The Metro Health Board of Directors has the authority to establish and amend benefit provisions of the plan.

Metro Health's annual pension expense is actuarially determined in accordance with GASB Statement No. 68, *Accounting and Financial Reporting for Pensions an Amendment of GASB Statement No. 27* ("GASB 68"). The net pension liability is calculated using the entry age normal level percentage of pay method. As allowable under the terms of GASB 68, Metro Health has elected to measure the net pension liability one year prior to the fiscal year end reporting date. The net pension liability measured as of June 30, 2016 was determined based on an actuarial valuation as of October 1, 2015. There are no significant changes known which would impact the total pension liability between the measurement date and the reporting date, other than typical plan experience.

For purposes of the June 30, 2016 measurement date, the number of plan participants consisted of the following:

Active participants	685
Vested terminated participants	928
Retirees, beneficiaries and disabled participants	323
	1,936

Note 9--Pension Plan--Continued

Changes in the net pension liability for the year ended June 30, 2017 are summarized as follows (in thousands):

	Total Pension Liability	Plan Fiduciary Net Position	Net Pension Liability
Balance, beginning of year	$ 96,414	$ 67,236	$ 29,178
Interest cost	4,482		4,482
Changes in assumptions	(24,906)		(24,906)
Differences between expected and actual plan experience	2,067		2,067
Benefit payments	(4,089)	(4,089)	-
Contributions from the employer		2,903	(2,903)
Net investment income:			
Expected investment earnings		3,166	(3,166)
Difference between expected and actual earnings		1,316	(1,316)
Balance, end of year	$ 73,968	$ 70,532	$ 3,436

The plan fiduciary net position as a percentage of the total pension liability was 95 percent and 70 percent at June 30, 2017 and July 1, 2016, respectively.

Significant actuarial assumptions used at each respective measurement date are as follows:

	June 30, 2016	July 1, 2015
Discount rate	7.00%	4.75%
Inflation	2.75%	2.75%
Investment rate of return	7.00%	4.75%
Mortality table	RP-2014 Employee and Healthy Annuitant, Scale MP-2015	RP-2014 Employee and Healthy Annuitant, Scale MP-2014

Discount rates are based on the expected rate of return on pension plan investments. The projection of cash flows used to determine the single discount rate for each fiscal year end assumed that employer contributions will be made based on minimum contribution projection under provisions of ERISA and Pension Protection Act of 2006 (including MAP-21) for future years. Based on the stated assumptions, the pension plan's fiduciary net position and future contributions were sufficient to finance the future benefit payments of the current plan members for all projection years. As a result, the long-term expected rate of return on pension plan investments was applied to all periods of the projected benefit payments to determine the total pension liability.

Note 9--Pension Plan--Continued

The long-term expected rate of return on pension plan investments of 7.00 percent at June 30, 2016, was determined using the expected future rates of return for the target asset allocation of the portfolio. The target allocation and best estimate geometric rates of return by asset class are summarized as follows:

	Portfolio Allocation	Long-Term Expected Return
U.S. large cap	25.0%	7.3%
U.S. mid cap	10.5%	7.5%
U.S. small cap	6.5%	7.8%
International developed	14.0%	6.8%
Emerging market	9.0%	12.6%
STRIPs	7.0%	2.1%
Corporate 10+ year	28.0%	5.1%

A one-percentage point change in the discount rate would have the following impact on the net pension liability at June 30, 2017 (in thousands):

	1% Decrease	1% Increase
Net pension liability	$ 9,056	$ (7,470)

The components of pension expense (income) for the year ended June 30, 2017 are summarized as follows (in thousands):

Interest cost	$ 4,482
Expected investment earnings	(3,166)
Amortization of deferred outflows and inflows:	
Difference between expected and actual plan experience	720
Difference between expected and actual investment earnings	(263)
Changes in assumptions	(8,678)
	$ (6,905)

Note 9--Pension Plan--Continued

Deferred outflows and inflows related to the net pension liability at June 30, 2017 are summarized as follows (in thousands):

	Deferred Outflows	Deferred Inflows
Changes in assumptions		$ 16,228
Difference between expected and actual plan experience	$ 1,347	
Difference between expected and actual investment earnings		1,053
	1,347	17,281
Contributions made after measurement date	2,171	
	$ 3,518	$ 17,281

Deferred outflows and inflows related to differences between expected and actual experience, as well as changes in assumptions, will be recognized into expense in the following fiscal years ended June 30 based upon the average future work life expectancy of plan participants (in thousands):

2018	$ 8,221
2019	7,187
2020	263
2021	263
	$ 15,934

At June 30, 2017, the reported fair value of the plan's investments based on the inputs used to value them is summarized as follows (in thousands):

	Level 1	Level 2	NAV	Total Fair Value
Equity securities	$ 49,494			$ 49,494
Fixed income securities		$ 19,555		19,555
Nonmarketable alternative investments			$ 1,483	1,483
	$ 49,494	$ 19,555	$ 1,483	$ 70,532

Note 10--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 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 75. 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's reported liability for postemployment benefits obligations is calculated using the entry age normal level percent of pay method. As allowable under the terms of GASB 75, the University has elected to measure the total postemployment liability one year prior to the fiscal year end reporting date. There are no significant changes known which would impact the total postemployment liability between the measurement date and the reporting date, other than typical plan experience.

Note 10--Postemployment Benefits--Continued

For purposes of the June 30, 2016 measurement date, the number of plan participants consisted of the following:

	Retiree Health and Welfare	Long-term Disability
Active employees	39,510	34,496
Retirees receiving benefits	9,099	
Surviving spouses	872	
Participants receiving disability benefits		610
	49,481	35,106

Changes in the total reported liability for postemployment benefits obligations for the year ended June 30, 2017 are summarized as follows (in thousands):

	Retiree Health and Welfare	Long-term Disability	Total
Balance, beginning of year	$ 2,532,952	$ 237,974	$ 2,770,926
Service cost	97,193	24,880	122,073
Interest cost	99,036	9,525	108,561
Changes in assumptions	244,109	10,932	255,041
Differences between expected and actual plan experience	5,259	8,769	14,028
Benefit payments	(47,893)	(24,409)	(72,302)
Balance, end of year	2,930,656	267,671	3,198,327
Less current portion	48,910	28,464	77,374
	$ 2,881,746	$ 239,207	$ 3,120,953

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 $674,252,000 at June 30, 2017.

In accordance with GASB 75, the University's liability for postemployment benefits obligations at June 30, 2017 is not reduced by the anticipated Medicare Retiree Drug Subsidy for future periods. This subsidy would reduce the total postemployment benefits liability by approximately $427,000,000.

Note 10--Postemployment Benefits--Continued

The University does not maintain a separate legal trust to house assets used to fund postemployment benefits, 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 reported postemployment benefits obligations at June 30, 2017 as a percentage of covered payroll of $3,568,918,000 was 90 percent.

Significant actuarial assumptions used at each respective measurement date are as follows:

	June 30, 2016	July 1, 2015
Discount rate*	2.85%	3.80%
Inflation rate	2.75%	2.75%
Immediate/ultimate administrative trend rate	0.0%/3.0%	0.0%/3.0%
Immediate/ultimate medical trend rate	7.0%/4.5%	7.0%/4.5%
Immediate/ultimate Rx trend rate	10.0%/4.5%	10.5%/4.5%
Increase in compensation rate	4.00%	4.00%
Mortality table**	RP-2014 White Collar Head Count Table, Scale MP-2015	RP-2014 White Collar Head Count Table, Scale MP-2014
Average future work life expectancy (years)		
– Retiree health and welfare	9.54	N/A
– Long-term disability	11.90	N/A

* Bond Buyer 20-year General Obligation Municipal Bond Index as of the last publication of the measurement period

** Based on the University's study of mortality experience from 2010-2014

A one-percentage point change in the discount rate and assumed health care cost trend rates would have the following impact on the liability for postemployment benefits obligations at June 30, 2017 (in thousands):

	1% Decrease	1% Increase
Discount Rate:		
Retiree health and welfare	$ 672,064	$ (516,547)
Long-term disability	$ 9,360	$ (8,600)
Health Care Trend Rate:		
Retiree health and welfare	$ (570,224)	$ 776,594
Long-term disability	$ (9,402)	$ 9,661

Note 10--Postemployment Benefits--Continued

The components of postemployment benefits expense for the year ended June 30, 2017 are summarized as follows (in thousands):

	Retiree Health and Welfare	Long-term Disability	Total
Service cost	$ 97,193	$ 24,880	$ 122,073
Interest cost	99,036	9,525	108,561
Amortization of deferred outflows	26,139	1,656	27,795
	$ 222,368	$ 36,061	$ 258,429

Deferred outflows related to postemployment benefits obligations at June 30, 2017 are summarized as follows (in thousands):

Changes in assumptions	$ 228,534
Difference between expected and actual plan experience	12,740
	241,274
Benefit payments made after measurement date	77,374
	$ 318,648

Deferred outflows related to changes in assumptions and the difference between expected and actual plan experience will be amortized into expense in the following years ended June 30 based upon the average future work life expectancy of plan participants (in thousands):

2018	$ 27,795
2019	27,795
2020	27,795
2021	27,795
2022	27,795
2023 and beyond	102,299
	$ 241,274

Note 11--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, while certain employees of the University's health system 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 year ended June 30, 2017 are summarized as follows (in thousands):

University contributions	$ 271,669
Employee contributions	$ 142,539
Payroll covered under plan	$ 3,568,918
Total payroll	$ 3,727,646

Note 12--Net Position

The composition of net position at June 30, 2017 is summarized as follows (in thousands):

Net investment in capital assets	$ 3,735,130
Restricted:	
Nonexpendable:	
Permanent endowment corpus	1,966,541
Expendable:	
Net appreciation of permanent endowments	1,828,744
Funds functioning as endowment	2,126,286
Restricted for operations and other	698,953
Unrestricted	3,071,403
	$ 13,427,057

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, 2017, substantially all of the unrestricted net position has been designated for various academic programs, research initiatives and capital projects.

Note 13--Federal Direct Lending Program

The University distributed $291,964,000 during the year ended June 30, 2017, 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 $2,429,000 at June 30, 2017, for DoED funding received subsequent to distribution.

Note 14--Commitments and Contingencies

Authorized expenditures for construction and other projects unexpended as of June 30, 2017 were $901,039,000. Of these expenditures, the University expects that $796,450,000 will be funded by internal sources, gifts, grants and future borrowings, $6,134,000 by the State Building Authority and the remaining $98,455,000 will be funded using unexpended bond 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, 2017, the University had committed, but not paid, a total of $4,766,977,000 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):

2018	$ 1,645,335
2019	1,124,702
2020	774,249
2021	444,811
2022	298,685
2023 and beyond	479,195
	$ 4,766,977

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 (in thousands):

	Capital	Operating
2018	$ 10,718	$ 45,271
2019	11,175	40,092
2020	10,589	37,319
2021	10,053	31,898
2022	10,211	28,343
2023-2027	46,267	84,848
2028-2032	47,139	8,300
2033-2037	32,022	88
2038-2039	6,624	
	184,798	$ 276,159
Less amount representing interest	87,538	
Present value of minimum lease payments	$ 97,260	

Note 14--Commitments and Contingencies--Continued

Operating lease expenses totaled $50,409,000 in 2017.

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 15--Operating Expenses by Function

Operating expenses by functional classification for the year ended June 30, 2017 are summarized as follows (in thousands):

	Compensation and Benefits	Supplies and Services	Depreciation	Scholarships and Fellowships	Total
Instruction	$ 939,548	$ 160,206			$ 1,099,754
Research	538,613	264,980			803,593
Public service	120,755	67,010			187,765
Academic support	237,819	60,278			298,097
Student services	87,885	24,075			111,960
Institutional support	181,106	55,556			236,662
Operations and maintenance of plant	40,575	275,789			316,364
Auxiliary enterprises	2,918,121	1,256,124			4,174,245
Depreciation			$ 537,670		537,670
Scholarships and fellowships				$ 143,932	143,932
	$ 5,064,422	$ 2,164,018	$ 537,670	$ 143,932	$ 7,910,042

Note 16--UM Health

Condensed financial information for UM Health, a blended component unit, before the elimination of certain intra-University transactions, as of and for the year ended June 30, 2017 is as follows (in thousands):

Condensed Statement of Net Position	
Assets:	
Current assets	$ 142,403
Noncurrent assets	258,190
Total assets	400,593
Deferred outflows	7,851
Total assets and deferred outflows	$ 408,444
Liabilities:	
Current liabilities	$ 56,449
Noncurrent liabilities	229,256
Total liabilities	285,705
Deferred inflows	20,258
Net position:	
Net investment in capital assets	18,691
Restricted:	
Nonexpendable	177
Expendable	11,569
Unrestricted	72,044
Total net position	102,481
Total liabilities, deferred inflows and net position	$ 408,444
Condensed Statement of Revenues, Expenses and Changes in Net Position	
Operating revenues	$ 377,202
Operating expenses other than depreciation expense	367,561
Depreciation expense	20,952
Operating loss	(11,311)
Nonoperating expenses, net	(9,512)
Other expenses, net	(1,974)
Net expenses before transfers	(22,797)
Transfers from other University units	45,000
Increase in net assets	22,203
Net position, beginning of year	80,278
Net position, end of year	$ 102,481
Condensed Statement of Cash Flows	
Net cash provided by operating activities	$ 16,916
Net cash provided by noncapital financing activities	38,113
Net cash used in capital and related financing activities	(63,550)
Net cash used in investing activities	(529)
Net decrease in cash and cash equivalents	(9,050)
Cash and cash equivalents, beginning of year	53,773
Cash and cash equivalents, end of year	$ 44,723

Required Supplementary Information (Unaudited)

Pension Plan

Changes in the net pension liability for the year ended June 30, 2017 are summarized as follows (in thousands):

	Total Pension Liability	Plan Fiduciary Net Position	Net Pension Liability
Balance, beginning of year	$ 96,414	$ 67,236	$ 29,178
Interest cost	4,482		4,482
Changes in assumptions	(24,906)		(24,906)
Differences between expected and actual plan experience	2,067		2,067
Benefit payments	(4,089)	(4,089)	-
Contributions from the employer		2,903	(2,903)
Net investment income:			
Expected investment earnings		3,166	(3,166)
Difference between expected and actual earnings		1,316	(1,316)
Balance, end of year	$ 73,968	$ 70,532	$ 3,436

The plan fiduciary net position as a percentage of the total pension liability was 95 percent and 70 percent at June 30, 2017 and July 1, 2016, respectively.

Pension Plan--Continued

Employer contributions in relation to actuarially determined contributions for the year ended June 30, 2017 are as follows (in thousands):

Employer contributions*	$ 2,171
Actuarially determined contributions	1,754
Excess contributions	$ 417

* Reflects no employer contributions after April 30, 2017

Significant methods and assumptions used to calculate the actuarially determined contributions are as follows:

Actuarially determined contributions	The plan is subject to funding requirements under the provisions of ERISA and the Pension Protection Act of 2006 (including MAP-21). The actuarially determined contributions represent the IRC Section 430 minimum required contributions.
Contributions in relation to actuarially determined contributions	Under IRC Section 430, the due date to pay minimum required contributions for the plan year is generally 8 ½ months after the end of the plan year. For the plan year ended September 30, 2016, contributions are due by June 15, 2017.
Actuarial cost method	Unit Credit method
Asset valuation method	24-month smoothed value of assets
Interest rate	First segment rate: 4.43%; Second segment rate: 5.91%; Third segment rate: 6.65%; Effective rate: 6.13%
Mortality	Prescribed by the Secretary of Treasury and described in Treasury regulation 1.430(h)(3)-1. Based on the RP-2000 sex distinct table that reflects projected mortality improvements 15 years into the future from the valuation date for non annuitants and 7 years into the future for annuitants.

Postemployment Benefits

The historical reconciliation of the total reported liability for postemployment benefits obligations for the year ended June 30, 2017 is summarized as follows (amounts in thousands):

Service cost	$ 122,073
Interest cost	108,561
Changes in assumptions	255,041
Differences between expected and actual plan experience	14,028
Benefit payments	(72,302)
Net changes	$ 427,401
Total liability, beginning of year	$ 2,770,926
Total liability, ending of year	$ 3,198,327
Covered employee payroll	$ 3,568,918
Total liability as a percentage of covered employee payroll	90%

Discount rates used in determining the total reported liability for postemployment benefits obligations were 2.85 percent and 3.80 percent at June 30 2017 and 2016, respectively.

UNIVERSITY OF MICHIGAN HOSPITALS

FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2017
with
REPORT OF INDEPENDENT AUDITORS

UNIVERSITY OF MICHIGAN HOSPITALS

June 30, 2017

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 ("UMH"), which consists of certain departments of the University of Michigan, which comprise the statement of net position as of June 30, 2017, and the related statements of revenues, expenses, and changes in net position and of cash flows for the year then ended.

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 audit. We conducted our audit 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 UMH'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 UMH'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 University of Michigan Hospitals, which consists of certain departments of the University of Michigan, as of June 30, 2017, and the changes in its financial position and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in Note 1, the financial statements of UMH 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 UMH. They do not purport to, and do not, present fairly the financial position of the University of Michigan as of June 30, 2017, and the changes in its financial position or its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

As discussed in Note 1 to the financial statements, UMH changed the manner in which it accounts for postemployment benefits other than pensions in 2017. Our opinion is not modified with respect to this matter.

Other Matter

The accompanying management's discussion and analysis on pages 3 through 18 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 audit 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 19, 2017

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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 (“UMH”) at June 30, 2017 and 2016 and its activities for the two fiscal years ended June 30, 2017. 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.

UMH is a part of the University of Michigan (the “University”), and is one of four University units that together comprise Michigan Medicine. Along with UMH, Michigan Medicine includes the University of Michigan Medical School (“Medical School”), Michigan Health Corporation and UM Health, a wholly owned corporation created to hold and develop Michigan Medicine’s statewide network of hospitals, hospital joint ventures and other hospital affiliations. Michigan Medicine 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 Michigan Medicine are provided by the University’s Executive Vice President for Medical Affairs.

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

Michigan Medicine and UMH have been recognized by several external organizations. During 2017, this recognition included:

- Earning Magnet status, the highest distinction in nursing, awarded by the American Nurses Credentialing Center based on meeting rigorous standards in quality patient care, nursing excellence, and innovations in the professional nursing practice.
- Being named to the U.S. News & World Report Honor Roll as the sixth best adult hospital in the nation, as well as Best Hospital in Michigan and Detroit Metro area and receiving top tier national rank in 15 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 ranked in more areas than any other Michigan children’s hospital, according to U.S. News & World Report.
- Being named to Becker’s Hospital Review’s annual list of the “100 Great Hospitals in America.”
- Being named as one of the 50 greenest hospitals in America by Becker’s Hospital Review based on the commitment to provide sustainable, environmentally-friendly patient care.
- For the eleventh consecutive time, Michigan Medicine earning an “A” from the nonprofit Leapfrog Group patient safety organization based on performance on a wide array of patient safety measures.
- The Medical School being ranked as one of the top medical schools in the country for training in research, primary care, geriatrics, internal medicine, women’s health, and family medicine by U.S News & World Report.
- Michigan Medicine being featured in Becker’s Hospital Review’s “150 Great Places to Work in Healthcare” for the fifth consecutive year.

Financial Highlights

	2017	2016
	(in millions)	
Operating Results		
Operating revenues	$ 3,244.3	$ 3,015.9
Operating income	255.3	190.4
Increase in net position	395.6	88.5

Net position has been restated at July 1, 2016 for the adoption of GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* ("GASB 75") and is summarized as follows (in millions):

Net position at June 30, 2016	$ 1,691.4
Adoption of GASB 75	(180.9)
Net position at July 1, 2016, as restated	$ 1,510.5

For purposes of management's discussion and analysis, comparative data for the statement of net position has been provided by reflecting the adoption of GASB 75 at June 30, 2016. The activity presented within the statement of revenues, expenses and changes in net position for the year ended June 30, 2016 does not include the impact of the adoption of GASB 75.

Operating revenues increased in 2017 due to continued growth in patient activity as well as increases in revenue per patient case. Operating expenses were higher in 2017 primarily due to costs associated with the growth in patient activity including increased expenses associated with compensation and benefits and supplies. Net position, which represents the residual interest in UMH's assets after liabilities are deducted, increased $395.6 million in 2017, driven principally by strong operating performance and unrealized market gains on investments.

Using the Financial Statements

UMH'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.

Statement of Net Position

The statement of net position presents the financial position of UMH at the end of the year and includes all assets, deferred outflows and liabilities of UMH. The difference between total assets and deferred outflows as compared to total liabilities – net position – is one indicator of the current financial condition of UMH, while the change in net position is an indication of whether the overall financial condition improved or worsened during the year. A schedule of UMH’s assets, deferred outflows, liabilities and net position at June 30, 2017 and 2016 is summarized as follows:

	2017	**2016**
	(in millions)	
Current assets	$ 792.4	$ 570.2
Noncurrent assets:		
Unexpended debt proceeds	83.3	
Investments	1,409.0	1,168.2
Capital assets, net	1,404.2	1,420.3
Other	18.5	21.7
Total assets	3,707.4	3,180.4
Deferred outflows	74.3	
Total assets and deferred outflows	3,781.7	3,180.4
Current liabilities	301.7	283.2
Noncurrent liabilities:		
Long-term debt	976.3	882.7
Obligations for postemployment benefits	559.8	464.5
Other	37.8	39.5
Total liabilities	1,875.6	1,669.9
Net position	$ 1,906.1	$ 1,510.5

Current assets consist primarily of cash and cash equivalents and accounts receivable. Cash and cash equivalents on deposit with the University totaled $432.4 million and $227.2 million at June 30, 2017 and 2016, 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 $272.0 million and $260.4 million at June 30, 2017 and 2016, respectively. The net increase in accounts receivable is consistent with increases in patient care revenues, due largely to increased activity.

Investments, consisting principally of long-term assets held in the University Endowment Fund, totaled $1,409.0 million and $1,168.2 million at June 30, 2017 and 2016, respectively. The increase in investments is due primarily to transfers from the Medical School for investment in the clinical mission of $129.7 million and unrealized gains of $109.5 million in 2017.

Total cash, cash equivalents and investments, excluding restricted cash and unexpended debt proceeds, amounted to $1.8 billion at June 30, 2017, which represents 233 days of operating expenses (excluding depreciation).

Net capital assets, defined as gross capital assets less accumulated depreciation, amounted to $1,404.2 million in 2017. Capital additions totaled $182.8 million in 2017, which included investments in clinical expansion as well as facility and infrastructure improvements.

Deferred outflows represent the consumption of net assets attributable to a future period and are primarily driven by activity associated with the University’s obligations for postemployment benefits. Deferred outflows totaled $74.3 million at June 30, 2017. There were no deferred outflows at June 30, 2016.

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 amounted to $81.8 million and $77.6 million at June 30, 2017 and 2016, respectively, primarily due to activity related to prior year estimates as well as the establishment of current year positions.

Total outstanding debt amounted to $1,006.9 million and $912.8 million at June 30, 2017 and 2016, respectively, with effective interest rates that averaged 3.7 percent. During 2017, UMH borrowed $123.2 million from the University, payable over 30 years at an average rate between 4.1 and 5.1 percent, to provide funding for the North Campus Clinical Pathology Laboratories Relocation and Renovation and the Brighton Center for Specialty Care projects, which are expected to be completed in 2018 and 2019, respectively.

During 2017, the University adopted GASB 75, which establishes new actuarial methods and discount rate standards for the measurement and recognition of the cost of postemployment benefits during the periods when employees render their services, superseding the requirements of GASB Statement No. 45. Adoption of this statement resulted in an increase in the reported liability for postemployment benefits obligations and a decrease in unrestricted net position of $180.9 million, as reflected in the comparative balances presented at June 30, 2016.

Obligations for postemployment benefits totaled $573.7 million and $476.9 million at June 30, 2017 and 2016, respectively, of which $13.9 million and $12.4 million is current. 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. The increase in the reported liability at June 30, 2017 was driven primarily by a decline in the discount rates used in developing the valuation as of the measurement date.

Net position represents the residual interest in UMH’s assets and deferred outflows after liabilities are deducted. The composition of UMH’s net position at June 30, 2017 and 2016 is summarized as follows:

	2017	**2016**
	(in millions)	
Net investment in capital assets	$ 446.3	$ 471.2
Restricted:		
Nonexpendable	6.6	4.9
Expendable	60.4	63.6
Unrestricted	1,392.8	970.8
	$ 1,906.1	$ 1,510.5

Net position invested in capital assets represents UMH’s capital assets net of accumulated depreciation, outstanding liability balances related to capital leases, and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets, inclusive of unspent debt proceeds.

Restricted nonexpendable net position includes the historical value (corpus) of gifts to UMH’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 UMH's results of operations. A comparison of revenues, expenses and other changes in net position for the two years ended June 30, 2017 is summarized as follows.

	2017	2016
	(in millions)	
Operating revenues	$ 3,244.3	$ 3,015.9
Operating expenses	2,989.0	2,825.5
Operating income	255.3	190.4
Total nonoperating and other revenues (expenses), net	136.5	(13.1)
Net revenues before transfers	391.8	177.3
Transfers from (to) other University units, net	3.8	(88.8)
Increase in net position	$ 395.6	$ 88.5

Operating Revenues

Patient care service revenue accounted for 98.8 percent of operating revenues and totaled $3,206.5 million in 2017, driven primarily by strong revenue per patient case as well as growth in patient volume. A comparative summary of patient activity statistics for the two years ended June 30, 2017, is as follows:

	2017	2016	% Change
Inpatient discharges	48,968	48,793	0.4%
Patient days	309,155	300,018	3.0%
Observation cases	19,015	18,199	4.5%
Surgeries	55,486	54,342	2.1%
Outpatient visits	2,445,738	2,424,473	0.9%
Adjusted cases	126,594	121,505	4.2%

Adjusted cases, which is an aggregate activity measurement combining inpatient discharges and outpatient/observation case activity, increased 4.2 percent to 126,594 cases in 2017.

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

The majority of patient care revenue is received under contractual arrangements with governmental payers (Medicare and Medicaid) and private insurers. UMH realized payment rate increases from the majority of private insurers and governmental payers as compared to 2016. The following table shows the distribution of gross charge activity by primary payer source for 2017 and 2016.

	2017	**2016**
Medicare	36.1%	35.9%
Medicaid	16.7%	16.7%
Blue Cross	29.8%	32.6%
Other	17.4%	14.8%

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 UMH 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. Recoveries are recognized in the financial statements as adjustments to prior year settlements at the time the appeals are resolved.

UMH regularly participates in initiatives with governmental and commercial payers to improve accessibility and quality of care for patients. UMH recognized $8.1 million and $8.9 million of other operating revenue to fund these initiatives in 2017 and 2016, respectively. Many of these initiatives are managed by the University of Michigan Medical Group. Accordingly, $4.0 million and $4.5 million was paid to the Medical School in 2017 and 2016, 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. These initiatives expired in 2017.

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. Michigan Medicine adopted a grant accounting model to recognize these meaningful use incentive payments, with gains being recognized when there is reasonable assurance that Michigan Medicine will comply with the meaningful use guidelines and that the funds will be received. A funds flow agreement between UMH 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 UMH and the Medical School. In 2015, UMH was also deemed eligible to receive facility meaningful use payments from both Medicare and Medicaid. Michigan Medicine has met the reasonable assurance guidelines; therefore, UMH recognized $4.9 million and $3.1 million as other operating revenue related to meaningful use incentive payments in 2017 and 2016, respectively.

Operating Expenses

A schedule of operating expenses for the two years ended June 30, 2017 is summarized as follows:

	2017	**2016**
	(in millions)	
Compensation	$ 1,154.0	$ 1,081.6
Benefits	381.2	347.8
Expenses reimbursed by other Michigan Medicine units	(34.6)	(35.6)
Supplies	739.9	704.0
Depreciation	198.6	196.0
Medical School faculty and other services	162.3	168.9
Michigan Medicine Administrative Services	84.3	87.4
Other operating expenses	303.3	275.4
Total operating expenses	$ 2,989.0	$ 2,825.5

In total, operating expenses increased 5.8 percent in 2017. Much of the growth in expenses is related to growth in patient activity, including increased expenses associated with compensation and benefits as well as medical surgical and pharmaceutical supplies.

Compensation and benefits increased 7.4 percent in 2017 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. The adoption of GASB 75 in 2017 also contributed to the increase in benefits expense as compared to 2016.

Supplies expense increased 5.1 percent in 2017. Increases during 2017 were driven by a combination of higher activity levels, particularly in operating rooms, specialty pharmacy prescriptions and infusion treatments, and the cost of prescription drugs.

Depreciation expense increased 1.3 percent in 2017 and includes $2.6 million of accelerated depreciation of assets that had no future utility as a result of building renovations.

Payments for services provided by other Michigan Medicine units include Medical School faculty and other services expense of $162.3 million and Michigan Medicine Administrative Services expense of $84.3 million in 2017. These expenses decreased by 3.8 percent, primarily driven by the shifting of programs out of the Michigan Medicine Administrative environment to other Michigan Medicine units, as well as a planned decrease in reimbursement for professional services provided by the Medical School.

Other operating expenses increased 10.1 percent in 2017, primarily due to increased contracted labor expense related to increased patient activity volumes, as well as increased routine maintenance costs.

Nonoperating and Other Revenues (Expenses)

A schedule of nonoperating and other revenues (expenses) for the two years ended June 30, 2017 is summarized as follows:

	2017	2016
	(in millions)	
Interest expense, net	$ (35.9)	$ (28.4)
Net investment income (loss)	167.0	(1.9)
Private gifts for other than capital and permanent endowment purposes	3.6	15.9
Capital and permanent endowment gifts	2.1	1.6
Loss on disposal of capital assets	(.3)	(.3)
Total nonoperating and other revenues (expenses), net	$ 136.5	$ (13.1)

Substantially all UMH 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 2017 provided a significant increase in UMH's revenue as market performance strengthened during the year. Net investment income for the two years ended June 30, 2017 is summarized as follows:

	2017	2016
	(in millions)	
Income distributions and other investment income	$ 57.5	$ 47.2
Net increase (decrease) in the fair value of investments	109.5	(49.1)
Net investment income (loss) including net realized and unrealized gains (losses)	$ 167.0	$ (1.9)

Transfers with Other University of Michigan Units

UMH 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. UMH reports these transfers as changes in net position, separately from the excess of revenues over expenses. UMH'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 two years ended June 30, 2017 are summarized as follows:

	2017	**2016**
	(in millions)	
Transfers to:		
Medical School/University of Michigan Medical Group		
Academic and non-patient care purposes	$ (100.6)	$ (181.8)
Other University units	(51.7)	(6.6)
	(152.3)	(188.4)
Transfers from:		
Medical School/University of Michigan Medical Group	151.5	96.9
Other University units	4.6	2.7
	156.1	99.6
Transfers from (to) other University units, net	$ 3.8	$ (88.8)

Transfers to the Medical School amounted to $100.6 million in 2017 in order to further support the academic and research missions of the Medical School.

In 2016, a new internal arrangement between UMH 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 2017, the Medical School made a non-recurring transfer of $129.7 million to UMH and these funds were invested in the University's Long Term Portfolio. In exchange for this investment, UMH distributes 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. Under this arrangement, UMH transferred $40.8 million to the Medical School during 2017. These amounts are reflected as transfers to other University units, net in the statement of revenues, expenses and changes in net position.

During 2017, UMH transferred $45.0 million to Metro Health Corporation ("Metro Health") upon completion of an affiliation with the University, pursuant to which UM Health became the sole corporate member of Metro Health. This contribution will support new strategic initiatives at Metro Health and is reflected as a transfer to other University units in the statement of revenues, expenses and changes in net position.

Statement of Cash Flows

The statement of cash flows provides additional information about UMH’s financial results by reporting the major sources and uses of cash. A summary of the statement of cash flows for the two years ended June 30, 2017 is as follows:

	2017	**2016**
	(in millions)	
Cash received from operations	$ 3,279.7	$ 3,120.2
Cash expended for operations	(2,800.9)	(2,649.9)
Net cash provided by operating activities	478.8	470.3
Net cash used in noncapital financing activities	(16.2)	(85.3)
Net cash used in capital and related financing activities	(100.2)	(183.1)
Net cash used in investing activities	(157.2)	(48.7)
Net increase in cash and cash equivalents	205.2	153.2
Cash and cash equivalents, beginning of year	227.2	74.0
Cash and cash equivalents, end of year	$ 432.4	$ 227.2

Cash received from operations primarily consists of patient care revenues. Net cash used in noncapital financing activities primarily consists of transfers from UMH to the Medical School in support of the Medical School’s academic and research missions. Net cash used in capital and related financing activities primarily consists of purchases of capital assets and proceeds from issuance of capital debt. Net cash used in investing activities primarily consists of investments transferred from the Medical School in support of the clinical mission, offset partially by realized investment income.

Economic Factors That May Affect the Future

During 2017, UMH continued to execute its long-term local and statewide clinical strategy to improve access to care with a range of investments in clinical capacity. In July 2016, the expansion of approximately 24,500 square feet within the surgical suite of University Hospital led to the opening of four new operating rooms. Also in July 2016, the Department of Psychiatry converted a 9,500 square foot area of University Hospital South from unused operating rooms to a state-of-the-art electroconvulsive therapy suite for patients with severe forms of depression and other illnesses. In October 2016, work was completed in University Hospital to convert existing laboratory space into five single inpatient rooms. In December 2016, the 7,000 square foot renovation of existing space in the Livonia Center for Specialty Care was finished to improve patient access to Otolaryngology and Urology services. Finally, in March 2017, the Brandon Newborn Intensive Care Unit increased capacity by opening six beds for the growing number of patients needing newborn ICU specialty care.

In 2017, work continued on new and existing projects, including the expansion of 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. Construction also continued on the 75,000 square foot West Ann Arbor Health Center relocation and expansion project, which will provide primary and specialty care, infusion services, an ambulatory diagnostic and treatment center, walk-in clinic, clinical pathology and radiology services. Work also continued on the expansion of operating room capacity in the University of Michigan Samuel and Jean Frankel Cardiovascular Center to install new hybrid technology. Finally, in 2017, work began on the 297,000 square foot Brighton Center for Specialty Care, which will 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 completed in 2018 (West Ann Arbor and first phase of Pathology Expansion Project) and 2019 (Brighton and second phase of Pathology Expansion Project).

UMH has a clinical strategy to expand access to more patients, locally and on a statewide basis, which is essential to the support of the academic mission of Michigan Medicine. In addition to improving capacity through facility, technology, quality, safety and efficiency, UMH also prioritized development and progress on clinical affiliations and population management programs. In December 2016, the University completed an affiliation with Metro Health, a 208-bed community hospital and health care provider with a network of ambulatory surgery and medical office spaces throughout greater Grand Rapids, whereby UM Health became the sole corporate member of Metro Health. This affiliation will position both UMH and Metro Health to more efficiently and effectively serve patients and the greater Grand Rapids community, in a rapidly changing health care environment. It will also enable Metro Health to expand its research capabilities, primary care and specialty services, and its use of complex medical technologies. In March 2017, the University also signed a non-binding letter of intent to establish a joint venture with the 133-bed St. Joseph Mercy Chelsea Hospital in Chelsea, Michigan to work together in improving health care access and quality for the local community and entire state.

Michigan Medicine continued to foster other existing affiliations with area hospitals and networks to enhance patient care, clinical research, physician recruitment and support services. Michigan Medicine collaborated with affiliated partners Mid-Michigan Health and Sparrow Children’s Center to continue to provide accessible, quality patient care, as well as with St. Joseph Mercy Ann Arbor on a medical care unit specializing in geriatric care through Michigan Medicine’s relationship with Trinity Health. Michigan Medicine also continued involvement with the Together Health Network as a referral provider for complex quaternary health care services.

In 2017, Michigan Medicine continued participation in the Physicians Organization of Michigan Accountable Care Organization (“POM ACO”). This participation allows Michigan Medicine 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. POM ACO continued as one of nearly 480 renewing Medicare Shared Savings Program Accountable Care Organizations (“ACOs”) in 2017, serving over nine million beneficiaries. This program was established as part of the Affordable Care Act and places emphasis on facilitating coordination and cooperation among providers to improve the quality of care for Medicare beneficiaries and on reducing unnecessary costs. In order to realize the savings associated with participation in this program, POM ACO receives a portion of the Medicare savings generated from lowering the growth in health care costs, dependent on the achievement of certain quality performance standards. In 2017, the Centers for Medicare and Medicaid Services reported performance year 2015 combined total savings of $466 million, which includes all ACOs experiences. POM ACO achieved a high rate of quality for the 2015 performance year and achieved a 1.4 percent savings in the cost of care.

These clinical affiliation agreements and population management programs are designed to expand community access, and improve patient/family and provider experiences across the continuum of care.

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 UMH. UMH’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.

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 UMH’s reimbursement by approximately $3.5 million to $7.0 million annually. Beginning in federal fiscal year 2014, Medicare Disproportionate Share Hospital (“DSH”) payments have also been reduced by the Centers for Medicare & Medicaid Services to coincide with the reduction in the uninsured population.

As a labor intensive organization, UMH’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. UMH continues to take steps to improve patient care while maintaining an effort to actively control its labor cost structure. A portion of UMH’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, could have a material effect on UMH’s future financial results.

In response to the additional cost and revenue pressures previously mentioned, Michigan Medicine 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 2017, the Board of Regents approved the establishment of the University of Michigan Health System Board (“Health System Board”) to advise the Board of Regents and Michigan Medicine leadership and provide governance over the clinical mission, including UMH. The Health System Board has 11 members, four of which are ex-officio and the remaining seven approved by the Board of Regents due to their knowledge and experience as health care and business leaders.

Management believes that UMH is poised to succeed in an environment where quality, appropriateness and innovation are rewarded. As part of Michigan Medicine, UMH 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 UMH 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 UMH to deal with the emerging strategic initiatives listed above.

UMH 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 UMH 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 UMH.

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

UNIVERSITY OF MICHIGAN HOSPITALS

Statement of Net Position

	June 30, 2017 (in thousands)
Assets and Deferred Outflows	
Current Assets:	
Cash and cash equivalents on deposit with the University	$ 432,431
Accounts receivable, net	271,956
Receivable from other University units	5,708
Current portion of pledges receivable, net	3,427
Inventory and other current assets	78,833
Total Current Assets	792,355
Noncurrent Assets:	
Unexpended debt proceeds on deposit with the University	83,343
Investments on deposit with the University	1,408,987
Pledges receivable, net	15,694
Other assets	2,814
Capital assets, net	1,404,200
Total Noncurrent Assets	2,915,038
Total Assets	3,707,393
Deferred Outflows	74,275
Total Assets and Deferred Outflows	$ 3,781,668
Liabilities and Net Position	
Current Liabilities:	
Accrued compensation	$ 94,349
Accounts payable and accrued expenses	63,626
Payable to other University units	17,389
Current portion of obligations for postemployment benefits	13,860
Current portion of long-term debt	30,622
Third party settlements and reserves	81,822
Total Current Liabilities	301,668
Noncurrent Liabilities:	
Long-term debt	976,259
Payable to other University units	3,541
Obligations for postemployment benefits	559,798
Other	34,335
Total Noncurrent Liabilities	1,573,933
Total Liabilities	1,875,601
Net Position:	
Net investment in capital assets	446,306
Restricted:	
Nonexpendable	6,586
Expendable	60,359
Unrestricted	1,392,816
Total Net Position	1,906,067
Total Liabilities and Net Position	$ 3,781,668

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

UNIVERSITY OF MICHIGAN HOSPITALS

Statement of Revenues, Expenses and Changes in Net Position

	Year Ended June 30, 2017 (in thousands)
Operating Revenues	
Net patient service revenue (net of provision for bad debts of $53,626)	$ 3,206,486
Other revenue	37,802
Total Operating Revenues	3,244,288
Operating Expenses	
Compensation and benefits	1,500,570
Medical School faculty and other services	162,264
Depreciation	198,582
Michigan Medicine Administrative Services	84,284
Supplies, services and other	1,043,326
Total Operating Expenses	2,989,026
Operating income	255,262
Nonoperating Revenues (Expenses)	
Interest expense, net	(35,885)
Net investment income	167,042
Private gifts for other than capital and permanent endowment purposes	3,563
Total Nonoperating Revenues, Net	134,720
Income before other revenues (expenses) and transfers	389,982
Other Revenues (Expenses)	
Capital and permanent endowment gifts	2,118
Loss on disposal of capital assets	(293)
Total Other Revenues, Net	1,825
Net revenues before transfers	391,807
Transfers from other University units, net	3,767
Increase in net position	395,574
Net Position, Beginning of Year	1,691,437
Adoption of GASB 75	(180,944)
Net Position, Beginning of Year, As Restated	1,510,493
Net Position, End of Year	$ 1,906,067

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

UNIVERSITY OF MICHIGAN HOSPITALS

Statement of Cash Flows

	Year Ended June 30, 2017 (in thousands)
Cash Flows from Operating Activities	
Received from patient care services	$ 3,199,280
Received from nonpatient sources	39,115
Expenses reimbursed by other University units	41,343
Payments to employees	(1,498,446)
Payments to suppliers	(986,438)
Payments to other University units	(316,089)
Net Cash Provided by Operating Activities	478,765
Cash Flows from Noncapital Financing Activities	
Private gifts and other receipts	4,986
Transfers to other University units, net	(21,164)
Net Cash Used in Noncapital Financing Activities	(16,178)
Cash Flows from Capital and Related Financing Activities	
Purchases of capital assets, net	(185,767)
Interest payments, net	(36,504)
Proceeds from issuance of capital debt	123,167
Principal payments on capital debt and capital lease obligations	(29,594)
Private gifts and other receipts	3,592
Transfers from Medical School for capital projects	24,931
Net Cash Used in Capital and Related Financing Activities	(100,175)
Cash Flows from Investing Activities	
Investment income	57,456
Increase in noncurrent investments and other assets	(131,296)
Unexpended capital debt proceeds	(83,343)
Net Cash Used in Investing Activities	(157,183)
Net increase in cash and cash equivalents	205,229
Cash and Cash Equivalents on Deposit with the University, Beginning of Year	227,202
Cash and Cash Equivalents on Deposit with the University, End of Year	$ 432,431

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

UNIVERSITY OF MICHIGAN HOSPITALS

Statement of Cash Flows--Continued

	Year Ended June 30, 2017 (in thousands)
Reconciliation of operating income to net cash provided by operating activities:	
Operating income	$ 255,262
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation expense	198,582
Changes in assets and liabilities:	
Accounts receivable, net	(11,560)
Receivable from other University units	1,122
Inventory and other current assets	(6,076)
Accrued compensation	9,488
Accounts payable and accrued expenses	(887)
Due to other University units	6,158
Third-party settlements and reserves	4,191
Obligations for postemployment benefits	96,760
Changes in deferred outflows	(74,275)
Net cash provided by operating activities	$ 478,765

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

UMH is an operating unit of Michigan Medicine. Along with UMH, Michigan Medicine includes the Medical School, Michigan Health Corporation and UM Health.

UMH 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 UMH 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 UMH, and all other professional revenue is recorded by the Medical School. Patient care expenses other than physician compensation are recorded by UMH, and the Medical School reimburses UMH for a portion of the costs associated with Medical School revenue. Physician compensation is recorded by the Medical School and UMH reimburses the Medical School for primary care and cancer center physicians. UMH also makes payments to the Medical School for faculty services provided to UMH 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"). UMH 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

During 2017, the University adopted GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, ("GASB 75"). This statement supersedes GASB Statement No. 45 and establishes new requirements for calculating and reporting the University's postemployment benefits. The adoption of GASB 75 has been reflected as of the beginning of the earliest period presented in the financial statements, resulting in an increase in obligations for postemployment benefits and a decrease in unrestricted net position of $180,944,000 at July 1, 2016.

Net position is categorized as:

- Net investment in capital assets: Capital assets, net of accumulated depreciation, unexpended debt proceeds, and outstanding principal balances of debt and capital lease liabilities 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 UMH'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 UMH pursuant to those stipulations or that expire by the passage of time. Such net position includes net appreciation of UMH'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.

Summary of Significant Accounting Policies: For purposes of the statement of cash flows, UMH 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, which totaled $81,559,000 at June 30, 2017. 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

UMH 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 fair market value 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 fair market value at each valuation date, subject to minimum holding and notice requirements.

Capital assets are recorded at cost or, if donated, at acquisition 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

UMH 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.

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

UMH'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 UMH's revenues and expenses are the result of exchange transactions. Certain significant revenue streams are classified as nonoperating revenues, most notably investment income.

UMH has agreements with third-party payers that provide for payments to UMH 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.

UMH provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. As UMH 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.

Note 2--Cash and Investments

Cash and investments at June 30, 2017, are summarized as follows (in thousands):

Cash and cash equivalents – University Investment Pool	$ 432,431
Investments:	
University Endowment Fund	1,408,911
Other investments	76
Total Investments	1,408,987
Total Cash, Cash Equivalents and Investments	$ 1,841,418

Note 2--Cash and Investments--Continued

In 2017, investments with a total fair value of $129,733,000 were transferred from the Medical School to UMH 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 UMH. 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 UMH for long-term investment purposes, but are not limited by donor stipulations requiring UMH to preserve principal in perpetuity. Substantially all of the amounts invested by UMH in this pool are funds functioning as endowment.

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, 2017, the Long Term Portfolio consisted of cash and equivalents (1 percent), fixed income securities (8 percent), U.S. and non-U.S. equities (12 percent), commingled funds (27 percent) and nonmarketable alternative investments (52 percent).

Note 2--Cash and Investments--Continued

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.

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 13 percent of the portfolio at June 30, 2017.

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

UMH receives quarterly distributions from the UEF based on the University's endowment spending rule. At June 30, 2017, 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 UMH 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.

GASB Statement No. 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, UMH 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 fair market values determined by the University.

Note 3--Pledges Receivable

The composition of pledges receivable at June 30, 2017 is summarized as follows (in thousands):

Gift pledges outstanding:	
Capital	$ 8,439
Operations	11,699
	20,138
Less:	
Allowance for uncollectible pledges	797
Unamortized discount to present value	220
Total pledges receivable, net	19,121
Less current portion	3,427
	$ 15,694

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

Payments on pledges receivable at June 30, 2017, are expected to be received in the following years ended June 30 (in thousands):

2018	$ 3,823
2019	2,962
2020	2,802
2021	2,775
2022	2,776
2023 and after	5,000
	$ 20,138

Note 4--Capital Assets

Capital assets activity for the year ended June 30, 2017 is summarized as follows (in thousands):

	Beginning Balance	Additions	Retirements	Ending Balance
Land	$ 30,423			$ 30,423
Land improvements	18,753	$ 586	$ 124	19,215
Buildings	1,939,833	48,927	167	1,988,593
Equipment	645,611	60,284	61,575	644,320
IT Infrastructure	417,822	36,437	104,246	350,013
Construction in progress	36,848	36,576		73,424
	3,089,290	182,810	166,112	3,105,988
Less accumulated depreciation	1,669,018	198,582	165,812	1,701,788
	$ 1,420,272	$ (15,772)	$ 300	$ 1,404,200

The increase in construction in progress of $36,576,000 in 2017 represents the amount of capital expenditures for new projects of $182,810,000 net of capital assets placed in service of $146,234,000. Retirements of $166,112,000 in 2017 are primarily related to fully depleted information technology and clinical equipment assets no longer in service. Interest of $2,287,000 was capitalized in 2017.

UMH’s capital assets, net includes assets under capital leases of $32,194,000 at June 30, 2017. These assets are principally comprised of the Northville Health Center building and equipment under capital lease.

As part of the Clinical Pathology project which involves expansion into the North Campus Research Complex, three buildings were transferred to UMH from the Medical School with a combined basis of $3,642,000 in 2017. Based on the future plans for these assets as part of this expansion, it was determined that many of the assets occupying these buildings had no future utility and their respective estimated useful lives were thereby shortened to coincide with the beginning of the renovations. This resulted in additional depreciation expense of $2,591,000 in 2017.

Note 5--Long-term Debt

Long-term debt at June 30, 2017 is summarized as follows (in thousands):

Payable to the University:	
2017, 4.05% to 5.05% through 2047	$ 104,590
unamortized premium	18,131
2012, 4.71% through 2025	44,760
2012, 3.23% to 3.25% through 2030	66,990
2012, 2.60% to 3.25% through 2033	84,310
2012, 3.65% through 2038	64,940
2012, 2.00% to 5.00% through 2042	56,710
2012, 2.00% to 5.00% through 2032	36,875
unamortized premium	1,444
2010, 0.68% to 5.00% through 2041	126,445
unamortized discount	(399)
2010, 3.20% to 3.64% through 2040	141,470
unamortized discount	(575)
2010, 2.00% to 5.00% through 2027	115,835
unamortized premium	5,849
2009, 2.00% to 5.00% through 2039	138,850
unamortized premium	656
	1,006,881
Less:	
Current portion of long-term debt	30,622
	$ 976,259

Note 5--Long-term Debt--Continued

Long-term debt activity for the year ended June 30, 2017 is summarized as follows (in thousands):

	Beginning Balance	Additions	Reductions	Ending Balance
Payable to the University	$ 912,807	$ 123,167	$ 29,093	$ 1,006,881

During 2017, UMH received proceeds of $123,167,000 from the University primarily to provide funding for the North Campus Clinical Pathology Laboratories Relocation and Renovation and the Brighton Center for Specialty Care projects.

UMH maintains fixed rate debt with an effective interest rate that averaged 3.7 percent in 2017.

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 (in thousands):

	Principal	Interest	Total
2018	$ 28,210	$ 38,604	$ 66,814
2019	30,200	37,535	67,735
2020	31,200	36,485	67,685
2021	35,295	35,437	70,732
2022	37,830	34,075	71,905
2023-2027	219,095	144,647	363,742
2028-2032	212,590	102,721	315,311
2033-2037	221,950	62,269	284,219
2038-2042	135,950	21,013	156,963
2043-2047	29,455	4,607	34,062
	981,775	$ 517,393	$ 1,499,168
Plus unamortized premiums, net	25,106		
	$ 1,006,881		

Note 5--Long-term Debt--Continued

UMH 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, 2017 range from 0.68 percent to 5.05 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 utilize excess interest paid by units to support future strategic projects.

Note 6--Third Party Payment and Reimbursement

A substantial portion of UMH'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 UMH 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. The significant settlements from prior periods that resolved in 2017 were related to non-government payers from 2016 and 2015 in the amounts of $13,670,000 and $6,045,000, respectively.

UMH 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 UMH 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 UMH's charity care policy for the year ended June 30, 2017, were $51,243,000. Bad debt provisions for the year ended June 30, 2017, were $53,626,000. Both items, when considered in total, reflect the impact of patients being insured under health insurance exchange products and the Medicaid expansion in Michigan.

Note 7--Transactions with Other University of Michigan Units

UMH has amounts receivable from and payable to other University units at June 30, 2017, as follows (in thousands):

Amounts receivable from other University units:	
Premium credit receivable from Veritas Insurance Corporation	$ 5,633
Other	75
	$ 5,708
Amounts payable to other University units:	
Medical School	$ 17,389
Other	3,541
	20,930
Less current portion	17,389
	$ 3,541

UMH 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. UMH 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 $5,633,000 were earned by UMH during 2017.

In conjunction with the implementation of a new electronic medical records and patient billing system, services provided by Michigan Medicine 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 UMH. While all cash received for facility services relates to UMH, 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 $17,389,000 was recorded for unapplied payments received by UMH that relate to services provided by the Medical School at June 30, 2017.

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

Other payable amounts consist principally of UMH's portion of expenses incurred by the Michigan Medicine Administrative Services organization.

UMH had various other transactions with University units for the years ended June 30, 2017, which are summarized as follows (in thousands):

Operating (expenses) revenues:	
Services provided by the Medical School:	
Clinical services	$ (162,264)
Amounts received from the Medical School to reimburse UMH for expenses related to Medical School revenue and operating support, net	34,597
Services provided by other University units	(54,185)
Services provided to other University units	5,624
Premium insurance payments, net of credits provided by Veritas	(18,717)
Services provided by Michigan Medicine Administrative Services	(84,284)
Rent and other	(2,797)
Equity transfers (to) from:	
Medical School:	
Academic and other non-patient care purposes, net	52,478
Other University units, net	(48,711)

UMH'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 UMH patients. Accordingly, UMH recognizes expense for these services in operating expenses. UMH incurred $162,264,000 of expense for services provided by the Medical School in 2017. UMH is also reimbursed for the salary cost of UMH 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 $34,597,000 in 2017.

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

In the course of normal operations, UMH both provides and receives services from other University units. Services received include benefits administration, grounds maintenance, parking services, information technology, security services, payroll and human resources. UMH included $54,185,000 in operating expenses for these services during 2017. Services provided by UMH include those of University Occupational Health Services and risk management administration. To compensate UMH for these services, various University units reimbursed UMH $5,624,000 during 2017, which is included as a reduction to total operating expenses.

Operating expenses include UMH'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 5 percent, of the ultimate losses as estimated by an independent actuary. Medical Professional Liability premiums and premium credits are allocated between UMH and the Medical School.

Certain UMH administrative functions are performed by a shared Michigan Medicine 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 Michigan Medicine organization in a cost-effective manner. Costs incurred by the Michigan Medicine Administrative Services environment are allocated to each participating organization based upon efforts expended for each function. In 2017, $84,284,000 of operating expense was allocated to UMH for the performance of these functions.

UMH 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 UMH leadership.

In 2016, a new internal arrangement between UMH 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 2017, the Medical School transferred $129,733,000 to UMH. Funds received were invested in the University's Long Term Portfolio. In exchange for this investment, UMH distributes 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. Under this arrangement, UMH transferred $40,793,000 to the Medical School during 2017. These amounts are reflected as transfers to other University units, net in the statement of revenues, expenses and changes in net position.

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

During 2017, UMH transferred $45,000,000 to Metro Health upon completion of an affiliation with the University, pursuant to which UM Health became the sole corporate member of Metro Health. This contribution will support new strategic initiatives at Metro Health and is reflected as a transfer to other University units in the statement of revenues, expenses and changes in net position.

Note 8--Postemployment Benefits

UMH 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 UMH's regular employees may become eligible for these benefits if they reach retirement age while working for UMH. For employees retiring on or after January 1, 1987, contributions toward health and welfare benefits are shared between UMH 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 UMH employees who are enrolled in a University sponsored long-term disability plan and qualify, based on disability status while working for UMH, to receive basic or expanded long-term disability benefits. Contributions toward the expanded long-term disability plan are shared between UMH 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 UMH.

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 75. 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.

Note 8--Postemployment Benefits--Continued

The University's recorded liability for postemployment benefits obligations was calculated using the entry age normal level percent of pay method. UMH's annual postemployment benefits expense and liability represents an allocation of UMH'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.

Changes in the total reported liability for UMH's postemployment benefits obligations for the year ended June 30, 2017 are summarized as follows (in thousands):

	Retiree Health and Welfare	Long-term Disability	Total
Balance, beginning of year	$ 449,346	$ 27,552	$ 476,898
Net benefits expense	31,718	1,458	33,176
Deferred outflows	62,723	861	63,584
Balance, end of year	543,787	29,871	573,658
Less current portion	10,441	3,419	13,860
	$ 533,346	$ 26,452	$ 559,798

At June 30, 2017, deferred outflows reported in the statement of net position include benefit payments made after the measurement date of $10,691,000. Since a portion of retiree medical services will be provided by UMH, the liability for postemployment benefit obligations is net of the related margin and fixed costs of providing those services which totaled $539,402,000 at June 30, 2017. The marginal cost reduction adjusts UMH's liability for postemployment benefits obligations to reflect the true marginal cost of care for those retirees who utilize UMH.

UMH 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. UMH's obligations for postemployment benefits at June 30, 2017 as a percentage of covered payroll of $1,128,206,000, was 51 percent.

Note 8--Postemployment Benefits--Continued

Significant actuarial assumptions used at each respective measurement date are as follows:

	June 30, 2016	July 1, 2015
Discount rate*	2.85%	3.80%
Inflation rate	2.75%	2.75%
Immediate/ultimate administrative trend rate	0.0%/3.0%	0.0%/3.0%
Immediate/ultimate medical trend rate	7.0%/4.5%	7.0%/4.5%
Immediate/ultimate Rx trend rate	10.0%/4.5%	10.5%/4.5%
Increase in compensation rate	4.00%	4.00%
Mortality table**	RP-2014 White Collar Head Count Table, Scale MP-2015	RP-2014 White Collar Head Count Table, Scale MP-2014
Average future work life expectancy (years)		
– Retiree health and welfare	9.54	N/A
– Long-term disability	11.90	N/A

* Bond Buyer 20-year General Obligation Municipal Bond Index as of the last publication of the measurement period

** Based on the University's study of mortality experience from 2010-2014

Note 9--Retirement Plan

UMH 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

Eligible employees may contribute up to 4.5 percent of their pay and UMH will contribute an amount equal to 9 percent of each employee's pay to the plan. UMH'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 UMH contributions. Contributions and covered payroll under the plan (excluding additional participant contributions) for the year ended June 30, 2017 are summarized as follows (in thousands):

UMH contributions	$ 84,276
Employee contributions	$ 44,218
Payroll covered under plan	$ 1,128,206
Total payroll	$ 1,156,011

Note 10--Commitments and Contingencies

UMH 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 (in thousands):

	Capital	Operating
2018	$ 4,473	$ 20,368
2019	4,473	18,870
2020	3,735	18,778
2021	3,045	18,528
2022	3,045	17,792
2023-2027	14,872	53,878
2028-2032	15,473	2,925
2033-2037	16,246	88
2038-2039	6,624	
	71,986	$ 151,227
Less amount representing interest	35,772	
Present value of minimum lease payments	$ 36,214	

Operating lease expenses, which include leases with other University units, totaled $34,238,000, in 2017.

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.

UMH 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.

M | ATHLETICS

FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2017
with
REPORT OF INDEPENDENT AUDITORS

INTERCOLLEGIATE ATHLETICS
OF THE UNIVERSITY OF MICHIGAN

June 30, 2017

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, which comprise the statement of net position as of June 30, 2017, and the related statements of revenues, expenses, and changes in net position and of cash flows for the year then ended.

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 audit. We conducted our audit 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 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
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Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Intercollegiate Athletics of the University of Michigan, which consists of certain departments of the University of Michigan, as of June 30, 2017, and the changes in its financial position and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of 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 as of June 30, 2017, and the changes in its financial position or its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

As discussed in Note 1 to the financial statements, ICA changed the manner in which it accounts for postemployment benefits other than pensions in 2017. Our opinion is not modified with respect to this matter.

Other Matter

The accompanying management's discussion and analysis on pages 3 through 9 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 audit 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 19, 2017

PricewaterhouseCoopers LLP, 500 Woodward Avenue, Detroit, MI 48226
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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, 2017 and 2016 and its activities for the two fiscal years ended June 30, 2017. 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, deferred outflows, 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.

During 2017, the University adopted GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* ("GASB 75"). This statement establishes new actuarial methods and discount rate standards for the measurement and recognition of the cost of postemployment benefits during the periods when employees render their services, superseding the requirements of GASB Statement No. 45. Adoption of this statement resulted in an increase in the reported liability for postemployment benefits obligations and a decrease in unrestricted net position of $9.7 million, as reflected in the comparative balances presented at June 30, 2016.

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 and deferred outflows of $904.5 million and liabilities of $402.6 million at June 30, 2017, as compared to assets of $832.3 million and liabilities of $347.3 million at June 30, 2016. Net position, which represents the residual interest in ICA's assets and deferred outflows after liabilities are deducted, totaled $501.9 million and $485.0 million at June 30, 2017 and 2016, respectively. ICA's increase in net position for the two years ended June 30, 2017 is summarized as follows:

	2017	2016
	(in millions)	
Operating revenues	$ 136.5	$ 118.4
Operating expenses	$ 176.0	$ 162.3
Nonoperating and other activities, net	$ 56.4	$ 51.7
Increase in net position	$ 16.9	$ 7.8

Net position has been restated at July 1, 2016 for the adoption of GASB 75, and is summarized as follows (in millions):

Net position at June 30, 2016	$ 494.7
Adoption of GASB 75	(9.7)
Net position at July 1, 2016, as restated	$ 485.0

For purposes of management's discussion and analysis, comparative data for the statement of net position has been provided by reflecting the adoption of GASB 75 at June 30, 2016. The activity presented within the statement of revenues, expenses and changes in net position for the year ended June 30, 2016 includes certain amounts that have been reclassified to conform with current year presentations and does not include the impact of the adoption of GASB 75.

ICA's operating revenues increased $18.1 million in 2017 due primarily to increases in licensing royalties, spectator admissions and conference distributions.

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 activities increased in 2017 due primarily to an increase in investment income.

ICA's operating expenses increased $13.7 million in 2017 due primarily to increases in compensation, sports equipment and apparel, student financial aid and game guarantees. ICA has also changed its presentation of game guarantees, reclassifying the expense from spectator admissions revenue to team and game expense.

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

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, deferred outflows and liabilities of ICA. The difference between total assets and deferred outflows as compared to 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, deferred outflows, liabilities and net position at June 30, 2017 and 2016 is summarized as follows:

	2017	**2016**
	(in thousands)	
Cash equivalents	$ 144,532	$ 137,043
Receivables and other assets, net	19,878	22,574
Advance sale of game tickets	(39,384)	(43,819)
Current portion of notes payable	(6,903)	(5,730)
Other current liabilities	(28,661)	(21,837)
Total Net Current Assets	89,462	88,231
Net Noncurrent Assets, Deferred Outflows and (Liabilities):		
Unexpended debt proceeds	12,783	18,222
Investments	108,408	92,111
Pledges receivable, net	83,496	90,133
Capital assets, net	527,950	469,508
Other noncurrent assets	3,358	2,750
Deferred outflows	4,146	
Unearned revenues	(11,585)	(12,911)
Obligations for postemployment benefits	(34,023)	(27,778)
Notes payable	(282,063)	(235,249)
Total Net Noncurrent Assets and Deferred Outflows	412,470	396,786
Net Position	$ 501,932	$ 485,017

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

ICA continues to make investments in its physical plant, financed by debt, capital gifts and reserves. In 2017, ICA completed the Richard L. Postma Family Clubhouse project and continued construction of the Stephen M. Ross Athletics South Competition and Performance project. ICA also commenced construction of the Football Performance Center. 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.

Outstanding debt as of June 30, 2017 and 2016 totaled $289.0 million and $241.0 million, respectively. Over the past several years, debt has provided funding for the Athletics South Competition and Performance project, the Crisler Center renovation and various other projects.

ICA's overall financial position improved in 2017 as net position increased $16.9 million. Net position as of June 30, 2017 and 2016 totaled $501.9 million and $485.0 million, respectively, and is summarized as follows:

	2017	**2016**
	(in thousands)	
Net investment in capital assets	$ 251,767	$ 246,751
Restricted:		
Nonexpendable	65,649	58,758
Expendable	177,836	170,031
Unrestricted	6,680	9,477
	$ 501,932	$ 485,017

Results of Operations

ICA measures its results of operations based on certain activities, which are summarized as follows for the two years ended June 30, 2017:

	2017	2016
	(in thousands)	
Revenues:		
Spectator admissions	$ 55,339	$ 49,763
Conference distributions	36,458	33,734
Preferred seating donations	30,513	29,406
Private gifts for other than capital and endowment purposes, current funds	7,591	7,540
Corporate sponsorship	18,361	15,987
Licensing royalties	12,014	7,843
Facilities revenues	6,743	4,488
Concessions and parking	4,511	3,986
Other revenues	3,081	2,599
Investment income, current funds	4,271	3,674
Total Revenues	178,882	159,020
Expenses and Other Uses:		
Salaries, wages and benefits, current funds	62,076	57,789
Financial aid	24,954	22,973
Team and game	34,656	31,293
Other operating and administrative	13,839	14,709
Equity transfers to the University, current funds	4,315	1,491
Operations and maintenance of plant, current funds	9,390	8,646
Deferred maintenance transfer	7,000	5,000
Debt service transfer	15,218	14,787
Total Expenses and Other Uses	171,448	156,688
Excess of revenues over expenses and other uses	7,434	2,332
Debt stabilization return		2,156
Adjusted excess of revenues over expenses and other uses	$ 7,434	$ 4,488

Adjusted excess of revenues over expenses and other uses increased $2.9 million in 2017.

ICA's adjusted revenues increased $19.9 million in 2017 due primarily to increases in licensing royalties, spectator admissions, and conference distributions. Spectator admissions increased $5.6 million due primarily to eight home football games in 2017 as compared to seven home football games in 2016. Licensing royalties increased $4.2 million due primarily to the impact of the new apparel agreement. Conference distributions increased $2.7 million due primarily to an increase in NCAA and postseason bowl games distributions.

ICA's adjusted expenses and other uses increased $14.8 million in 2017 primarily due to increases in compensation, team and game expenses, deferred maintenance fund transfer and financial aid. Compensation increased $4.3 million in 2017 primarily due to inflationary salary increases and contractual obligations. Team and game expenses increased $3.4 million due primarily to increased sports equipment and apparel costs and increased team meal costs. Financial aid increased $2.0 million in 2017 due primarily to tuition increases and changes to cost of attendance rules.

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 summary of the statement of cash flows for the years ended June 30, 2017 and 2016 is as follows:

	2017	2016
	(in thousands)	
Net cash used in operating activities	$ (19,149)	$ (1,950)
Net cash provided by noncapital financing activities	36,030	35,194
Net cash (used in) provided by capital and related financing activities	(17,644)	6,090
Net cash provided by (used in) investing activities	8,252	(14,932)
Net increase in cash equivalents	$ 7,489	$ 24,402

The activity presented within the statement of cash flows for the year ended June 30, 2016 includes certain amounts that have been reclassified to conform with current year presentations. Cash received from operations primarily consists of spectator admissions, conference distributions, corporate sponsorships and other media rights, and licensing royalties. Cash received from noncapital financing primarily consists of private gifts and preferred seating donations. ICA continued to invest in its physical plant by devoting $12.2 million and $12.1 million in net cash for capital and related financing activities in 2017 and 2016, respectively.

Economic Factors That Will Affect the Future

ICA continues 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 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. The anticipated completion date for the Athletics South Competition and Performance project is December 2017.

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 the success of 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, 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, 2017 (in thousands)
Assets and Deferred Outflows	
Current Assets:	
Cash equivalents on deposit with the University	$ 144,532
Accounts receivable, net	3,451
Current portion of pledges receivable, net	13,868
Current portion of prepaid expenses and other assets	2,559
Total Current Assets	164,410
Noncurrent Assets:	
Unexpended debt proceeds on deposit with the University	12,783
Endowment investments on deposit with the University	108,408
Pledges receivable, net	83,496
Prepaid expenses and other assets	3,358
Capital assets, net	527,950
Total Noncurrent Assets	735,995
Total Assets	900,405
Deferred Outflows	4,146
Total Assets and Deferred Outflows	$ 904,551
Liabilities and Net Position	
Current Liabilities:	
Accounts payable and accrued expenses	$ 20,359
Accrued compensation	4,962
Advance sale of game tickets	39,384
Current portion of unearned revenues	3,340
Current portion of notes payable to the University	6,903
Total Current Liabilities	74,948
Noncurrent Liabilities:	
Unearned revenues	11,585
Obligations for postemployment benefits	34,023
Notes payable to the University	282,063
Total Noncurrent Liabilities	327,671
Total Liabilities	402,619
Net Position:	
Net investment in capital assets	251,767
Restricted:	
Nonexpendable	65,649
Expendable	177,836
Unrestricted	6,680
Total Net Position	501,932
Total Liabilities and Net Position	$ 904,551

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, 2017 (in thousands)
Operating Revenues	
Spectator admissions	$ 55,339
Conference distributions	36,458
Corporate sponsorships and other media rights	18,361
Licensing royalties	12,014
Facilities revenues	6,743
Concessions, publications and parking	4,511
Other revenues	3,081
Total Operating Revenues	136,507
Operating Expenses	
Salaries, wages and benefits	64,391
Financial aid	24,954
Team and game	36,656
Other operating and administrative	13,839
Operations and maintenance of plant	11,852
Depreciation	24,283
Total Operating Expenses	175,975
Operating loss	(39,468)
Nonoperating Revenues (Expenses)	
Private gifts for other than capital and endowment purposes	7,599
Preferred seating donations	30,513
Net investment income	12,671
Interest expense and other, net	(9,202)
Total Nonoperating Revenues, Net	41,581
Income before other revenues and transfers	2,113
Other Revenues	
Capital gifts	11,247
Private gifts for permanent endowment purposes	6,612
Total Other Revenues	17,859
Net revenues before transfers	19,972
Transfers to other University departments, net	(3,057)
Increase in net position	16,915
Net Position, Beginning of Year	494,757
Adoption of GASB 75	(9,740)
Net Position, Beginning of Year, as Restated	485,017
Net Position, End of Year	$ 501,932

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, 2017 (in thousands)
Cash Flows from Operating Activities	
Spectator admissions	$ 51,002
Conference distributions	38,194
Corporate sponsorships and other media rights	13,762
Licensing royalties	12,390
Facilities revenues	6,077
Concessions, publications and parking	4,298
Other revenues	3,013
Payments for salaries, wages and benefits	(63,799)
Payments for financial aid	(24,954)
Payments for team and game expenses	(31,119)
Payments for other operating and administrative expenses	(16,273)
Payments for operations and maintenance of plant	(11,740)
Net Cash Used in Operating Activities	(19,149)
Cash Flows from Noncapital Financing Activities	
Private gifts for other than capital and endowment purposes	8,574
Preferred seating donations	30,513
Transfers to other University departments, net	(3,057)
Net Cash Provided by Noncapital Financing Activities	36,030
Cash Flows from Capital and Related Financing Activities	
Capital gifts	18,405
Proceeds from issuance of capital debt	55,124
Principal payments on capital debt	(7,025)
Interest payments on capital debt	(8,607)
Purchases of capital assets	(75,541)
Net Cash Used in Capital and Related Financing Activities	(17,644)
Cash Flows from Investing Activities	
Investment income	4,601
Increase in investments on deposit with the University, net	(1,788)
Unexpended capital debt proceeds on deposit with the University	5,439
Net Cash Provided by Investing Activities	8,252
Net increase in cash equivalents	7,489
Cash Equivalents on Deposit with the University, Beginning of Year	137,043
Cash Equivalents on Deposit with the University, End of Year	$ 144,532

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, 2017 (in thousands)
Reconciliation of operating loss to net cash used in operating activities:	
Operating loss	$ (39,468)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation expense	24,283
Changes in assets and liabilities:	
Accounts receivable, net	2,237
Prepaid expenses and other assets	(1,648)
Accounts payable and accrued expenses	(211)
Accrued compensation	5,862
Advance sale of game tickets	(4,435)
Unearned revenues	(1,623)
Changes in deferred outflows	(4,146)
Net cash used in operating activities	$ (19,149)

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, deferred outflows, 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.

During 2017, the University adopted GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions,* ("GASB 75"). This statement supersedes GASB Statement No. 45 and establishes new requirements for calculating and reporting the University's postemployment benefits. The adoption of GASB 75 has been reflected as of the beginning of the earliest period presented in the financial statements, resulting in an increase in obligations for postemployment benefits and a decrease in unrestricted net position of $9,740,000 at July 1, 2016.

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, unspent 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.

- 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.

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 fair market value 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 fair market value at each valuation date, subject to minimum holding and notice requirements.

Capital assets are recorded at cost or, if donated, at acquisition 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 associated with 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 $750,000 at June 30, 2017 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 $32,552,000 at June 30, 2017, 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 $3,886,000 in 2017.

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 and other is recorded net of capitalized interest and gain (loss) on disposal of plant assets.

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.

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. 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, 2017, the Long Term Portfolio consisted of cash and equivalents (1 percent), fixed income securities (8 percent), U.S. and non-U.S. equities (12 percent), commingled funds (27 percent) and nonmarketable alternative investments (52 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 13 percent of the portfolio at June 30, 2017.

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. The annual distribution rate is 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 Statement No. 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, 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 fair market values determined by the University.

Note 3--Pledges Receivable

The composition of pledges receivable at June 30, 2017 is summarized as follows (in thousands):

Gift pledges outstanding:	
Capital	$ 95,909
Operations	5,238
	101,147
Less:	
Allowance for uncollectible pledges	2,215
Unamortized discount to present value	1,568
Total pledges receivable, net	97,364
Less current portion	13,868
	$ 83,496

Payments on pledges receivable at June 30, 2017 are expected to be received in the following years ended June 30 (in thousands):

2018	$ 14,267
2019	10,917
2020	9,130
2021	14,067
2022	8,601
2023 and after	44,165
	$ 101,147

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 $18,311,000 at June 30, 2017, are not recognized as assets in the accompanying financial statements. Pledges totaling $13,475,000 at June 30, 2017 for the use of football suites in future years have not met time requirements and have not been recorded in the financial statements. 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.

Notes to Financial Statements--Continued

Note 4--Capital Assets

Capital assets activity for the year ended June 30, 2017 is summarized as follows (in thousands):

	Beginning Balance	Additions	Retirements	Ending Balance
Land	$ 1,818			$ 1,818
Land improvements	19,184	$ 2,589		21,773
Infrastructure	2,840			2,840
Buildings	604,169	11,110	$ 7	615,272
Construction in progress, net	30,474	67,632		98,106
Equipment	9,662	1,406	474	10,594
	668,147	82,737	481	750,403
Less accumulated depreciation	198,639	24,283	469	222,453
	$ 469,508	$ 58,454	$ 12	$ 527,950

In 2017, the increase in construction in progress of $67,632,000 represents the amount of capital expenditures for new projects of $81,331,000 net of capital assets placed in service of $13,699,000.

Note 5--Notes Payable to the University of Michigan

Long-term debt activity for the year ended June 30, 2017 is summarized as follows (in thousands):

	Beginning Balance	Additions	Reductions	Ending Balance
Payable to the University	$ 240,979	$ 55,124	$ 7,137	$ 288,966
Less current portion	5,730			6,903
	$ 235,249			$ 282,063

In 2017, ICA borrowed $55,124,000 to finance the construction of the Stephen M. Ross Athletics South Competition and Performance project.

Note 5--Notes Payable to the University of Michigan

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 by units to support future strategic projects. Fixed interest rates on debt obligations outstanding at June 30, 2017 range from 2.1 to 5.4 percent.

In 2017, ICA incurred interest costs totaling $9,920,000.

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

	Principal	Interest
2018	$ 6,320	$ 11,446
2019	10,865	11,598
2020	12,370	11,176
2021	12,640	10,728
2022	12,960	10,267
2023-2027	48,535	45,203
2028-2032	53,870	35,117
2033-2037	72,845	21,514
2038-2042	37,035	7,456
2043-2047	13,310	2,079
	280,750	$ 166,584
Plus unamortized premiums	8,216	
	$ 288,966	

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 $20,625,000 for 2017. In addition, ICA paid Michigan Medicine $622,000 in 2017, for medical services provided to student-athletes.

ICA also reimbursed the University for certain other services received in the year ended June 30, 2017 as follows (in thousands):

Utilities	$ 3,270
Security	2,026
Plant services	1,950
Insurance coverage	855
Telecommunications	731
Business and finance allocation	647
Budget administration allocation	517
Other	714
	$ 10,710

ICA provided the University with $1,440,000 in connection with the Big Ten Network distribution received from the Big Ten Conference in 2017. 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 2017, ICA received $1,002,000, 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 75. 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's recorded liability for postemployment benefits obligations was calculated using the entry age normal level percent of pay method. 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 year ended June 30, 2017 are summarized as follows (in thousands):

	Retiree Health and Welfare	Long-term Disability	Total
Balance, beginning of year	$ 27,609	$ 862	$ 28,471
Net benefits expense	3,082	46	3,128
Deferred outflows	3,311	22	3,333
Balance, end of year	34,002	930	34,932
Less current portion	820	89	909
	$ 33,182	$ 841	$ 34,023

At June 30, 2017, deferred outflows reported in the statement of net position include benefit payments made after the measurement date of $813,000. 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, 2017, as a percentage of covered payroll of $46,457,000 was 75 percent.

Significant actuarial assumptions used at each respective measurement date are as follows:

	June 30, 2016	July 1, 2015
Discount rate*	2.85%	3.80%
Inflation rate	2.75%	2.75%
Immediate/ultimate administrative trend rate	0.0%/3.0%	0.0%/3.0%
Immediate/ultimate medical trend rate	7.0%/4.5%	7.0%/4.5%
Immediate/ultimate Rx trend rate	10.0%/4.5%	10.5%/4.5%
Increase in compensation rate	4.00%	4.00%
Mortality table**	RP-2014 White Collar Head Count Table, Scale MP-2015	RP-2014 White Collar Head Count Table, Scale MP-2014
Average future work life expectancy (years)		
– Retiree health and welfare	9.54	N/A
– Long-term disability	11.90	N/A

* Bond Buyer 20-year General Obligation Municipal Bond Index as of the last publication of the measurement period

** Based on the University's study of mortality experience from 2010-2014

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 year ended June 30, 2017 are summarized as follows (in thousands):

ICA contributions	$ 2,659
Employee contributions	$ 1,395
Payroll covered under plan	$ 46,457
Total payroll	$ 50,371

Note 9--Commitments and Contingencies

ICA's commitments to complete construction in progress and other authorized acquisitions of property, plant and equipment amounted to $105,701,000 as of June 30, 2017, which will be funded with cash on hand, gifts and future borrowings.

THE VERITAS INSURANCE CORPORATION

FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2017 and 2016
with
REPORT OF INDEPENDENT AUDITORS

THE VERITAS INSURANCE CORPORATION

June 30, 2017 and 2016

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, a component unit of the University of Michigan, which comprise the statement of net position as of June 30, 2017 and 2016, and the related statements of revenues, expenses and changes in net position and of cash flows for the years then ended.

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.

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Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Veritas Insurance Corporation, a component unit of the University of Michigan, as of June 30, 2017 and 2016, 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.

Other Matter

The accompanying management's discussion and analysis on pages 3 through 11 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 19, 2017

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THE VERITAS INSURANCE CORPORATION

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, 2017 and 2016 and its activities for the three fiscal years ended June 30, 2017. 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 2017 and 2016, 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, 2017, the Corporation's net position increased by $8.5 million to $56.5 million. Net investment gains increased net position by $17.8 million, while operating revenues, net of expenses, decreased net position by $9.3 million.

As a result of favorable loss experience and investment returns in prior years, capital and surplus were sufficient to provide premium credits totaling $15.0 million in 2017. The premium credits were accrued in the accompanying financial statements at June 30, 2017.

Premium credits to be distributed as of June 30, 2017, 2016 and 2015 are as follows:

	2017	**2016** (in millions)	**2015**
Medical professional liability	$ 10.3	$ 9.1	$ 12.5
Educators' legal liability	2.4	2.8	2.6
Property damage		0.2	0.7
General liability		0.1	0.1
Hospital premises liability	0.1	0.1	0.1
Workers' compensation liability	2.2		
Total premium credit	$ 15.0	$ 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, 2017 and 2016, 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, 2017, 2016 and 2015 is summarized as follows:

	2017	**2016** (in millions)	**2015**
Cash equivalents and investments	$ 217.3	$ 199.2	$ 207.9
Other assets	2.8	2.3	1.9
Total assets	220.1	201.5	209.8
Reserves for losses and loss adjustment expenses	143.4	136.2	126.6
Return premiums payable to affiliated units	15.0	12.3	16.0
Other liabilities	5.2	5.0	9.3
Total liabilities	163.6	153.5	151.9
Unrestricted net position	$ 56.5	$ 48.0	$ 57.9

Assets: The assets of the Corporation totaled $220.1 million at June 30, 2017, an increase of $18.6 million, or 9.2 percent from the prior year. The increase is primarily due to investment gains earned during the year.

The major components of invested assets at June 30, 2017 were $250,000 in cash equivalents, $100.9 million in the University's Daily and Monthly Portfolios and $116.1 million in the University's Long Term Portfolio. 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 asset allocations for both 2017 and 2016 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, 2017, reserves for losses and LAE totaled $143.4 million, an increase of $7.2 million, or 5.3 percent from the prior year. Of this amount, $55.7 million related to reserves on known claims and $87.7 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 5 percent for 2017 and 6 percent for 2016. The increase in reserves for losses and LAE is primarily due to higher losses incurred compared to payout of claims in 2017.

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

The activity in the reserves for losses and LAE for the three years ended June 30, 2017 is summarized as follows:

	2017	2016 (in millions)	2015
Reserves for losses and LAE, beginning of year	$ 136.2	$ 126.6	$ 126.4
Less reinsurance recoverable on unpaid losses	1.1	1.3	1.1
Net reserves for losses and LAE, beginning of year	135.1	125.3	125.3
Incurred losses and LAE related to:			
Current year	44.0	41.7	39.5
Prior years	(7.5)	(5.0)	(9.6)
Total incurred losses and LAE	36.5	36.7	29.9
Total paid losses and LAE	(29.2)	(26.9)	(29.9)
Net reserves for losses and LAE, end of year	142.4	135.1	125.3
Reinsurance recoverable on unpaid losses	1.0	1.1	1.3
Reserves for losses and LAE, end of year	$ 143.4	$ 136.2	$ 126.6

Reserves for losses and LAE by line of business at June 30, 2017, 2016 and 2015 are summarized as follows:

	2017	2016	2015
Medical professional liability	78.2%	76.6%	72.2%
Workers' compensation	10.0	11.4	12.5
Educators' legal liability	5.6	6.0	7.6
Property damage	3.8	3.4	4.4
Basket aggregate liability and excess insurance	1.3	1.6	2.1
Auto liability	0.5	0.5	1.0
General liability	0.4	0.3	0.1
Hospital premises liability	0.2	0.2	0.1
	100.0%	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 $15.0 million and $12.3 million at June 30, 2017 and 2016, respectively.

Net Position: Net position is unrestricted and totaled $56.5 million and $48.0 million at June 30, 2017 and 2016, respectively. This is in excess of the $250,000 minimum unimpaired paid-in capital and surplus required by the state of Vermont. The increase in 2017 is due primarily to investment gains earned 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, 2017 is summarized as follows:

	2017	2016 (in millions)	2015
Direct written premiums	$ 43.1	$ 41.6	$ 41.5
Change in unearned premiums	0.3	(0.2)	0.1
Returned premiums	(15.0)	(12.3)	(16.0)
Ceded written premiums expired	(1.0)	(0.9)	(1.0)
Total operating revenues	27.4	28.2	24.6
Losses and loss adjustment expenses	36.5	36.7	29.9
Other operating expenses	0.2	0.3	0.2
Total operating expenses	36.7	37.0	30.1
Operating loss	(9.3)	(8.8)	(5.5)
Nonoperating revenues (expenses)	17.8	(1.1)	4.8
Increase (decrease) in net position	$ 8.5	$ (9.9)	$ (0.7)

The Corporation's operating revenues totaled $27.4 million in 2017, compared to $28.2 million in 2016, a decrease of $0.8 million, or 2.8 percent. The decrease is primarily due to higher returned premiums as the $15.0 million in premium credits declared in 2017 were $2.7 million higher 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 2017 were $1.5 million higher than 2016.

Returned premiums are the Corporation's declared premium credits, a distribution of unrestricted net position in excess of adopted goals. Returned premiums of $15.0 million and $12.3 million during 2017 and 2016, 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, 2017 are summarized as follows:

	2017	**2016**	**2015**
Medical professional liability	63.3%	57.5%	54.4%
Workers' compensation	13.1	20.2	21.1
Educators' legal liability	4.2	5.4	6.4
Property damage	13.5	11.2	11.0
Basket aggregate liability and excess insurance	4.3	4.0	5.1
Auto liability	1.2	1.4	1.6
General liability	0.4	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, 2017 are summarized as follows:

	2017	**2016** (in millions)	**2015**
Incurred losses and LAE related to:			
Current year	$ 44.0	$ 41.7	$ 39.5
Prior years	(7.5)	(5.0)	(9.6)
Total incurred losses and LAE	$ 36.5	$ 36.7	$ 29.9

In 2017, total incurred losses and LAE decreased $0.2 million, or 0.5 percent, to $36.5 million. The decrease is primarily due to a combination of increased exposures and expected severity resulting in an increase in current policy year incurred losses to $44.0 million, and a $2.5 million decrease in loss and LAE expenses related to favorable claim development of prior policy year incurred losses.

In 2017, favorable prior year loss development totaling $7.5 million is mainly attributable to favorable development in Medical Professional Liability ("MPL"). For MPL, prior year ultimate losses decreased by $6.0 million mainly due to more favorable development than actuarially expected for policy years 2013/14 and 2014/15 offset by an unfavorable experience for policy year 2006/07. Property losses decreased by $1.6 million due to more favorable development than actuarially expected for policy year 2015/16. Workers' Compensation ("WC") losses increased by $0.3 million due to unfavorable actuarial development. Other lines of business in aggregate saw favorable development of $0.2 million. Due to the favorable prior year loss development, Veritas has reduced its forecast of ultimate losses by $6.6 million, resulting in a corresponding reduction in the calculated reserves as of June 30, 2017.

In 2016, favorable prior year loss development totaling $5.0 million is mainly attributable to favorable development in 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. 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.

Nonoperating revenues, representing net investment income, increased from a loss of $1.1 million in 2016 to a net investment gain of $17.8 million in 2017, an increase of $18.9 million. This increase was primarily a result of improvement in 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 three years ended June 30, 2017 is as follows:

	2017	**2016** (in millions)	**2015**
Cash received from operations	$ 30.8	$ 25.6	$ 30.8
Cash expended for operations	(30.6)	(33.2)	(31.2)
Net cash provided by (used in) operating activities	0.2	(7.6)	(0.4)
Net cash (used in) provided by investing activities	(0.2)	7.6	0.4
Net change in cash equivalents	$ -	$ -	$ -

The primary source of cash from operations is the collection of premiums. Premiums collected totaled $30.8 million in 2017 and $25.6 million in 2016. The $5.2 million increase in premiums collected is primarily due to a $3.7 million decrease 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 $30.6 million in 2017, as compared to $33.2 million in 2016. The decrease is due to decreased payments for losses and LAE paid in the current year.

Cash provided by investing activities decreased $7.8 million in 2017 compared to 2016, due primarily to a higher volume of investment purchases.

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 5 percent was used in 2017 and a discount rate of 6 percent was used for each of the years ended 2016 and 2015. 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 25, 2017 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.

THE VERITAS INSURANCE CORPORATION

Statement of Net Position

	June 30, 2017	June 30, 2016
Assets		
Current Assets:		
Cash equivalents	**$ 250,000**	$ 250,000
Investments on deposit with the University	**100,937,611**	91,467,750
Losses receivable from the University	**852,235**	16,462
Premium tax recoverable	**42,893**	35,041
Prepaid premium tax	**10,188**	11,224
Prepaid reinsurance premiums	**316,742**	316,741
Reinsurance recoverable on paid losses	**608,964**	823,149
Total Current Assets	**103,018,633**	92,920,367
Noncurrent Assets:		
Investments on deposit with the University	**116,146,173**	107,520,380
Reinsurance recoverable on unpaid losses	**968,400**	1,072,935
Total Noncurrent Assets	**117,114,573**	108,593,315
Total Assets	**$ 220,133,206**	$ 201,513,682
Liabilities and Net Position		
Current Liabilities:		
Reserves for losses and loss adjustment expenses	**$ 46,728,790**	$ 43,102,964
Return premiums payable to affiliated units	**15,050,000**	12,295,000
Unearned premium reserves	**3,745,732**	4,042,991
Losses payable and accrued liabilities	**1,404,145**	887,021
Total Current Liabilities	**66,928,667**	60,327,976
Noncurrent Liabilities:		
Reserves for losses and loss adjustment expenses	**96,642,099**	93,143,369
Total Liabilities	**163,570,766**	153,471,345
Net Position:		
Unrestricted	**56,562,440**	48,042,337
Total Net Position	**56,562,440**	48,042,337
Total Liabilities and Net Position	**$ 220,133,206**	$ 201,513,682

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

THE VERITAS INSURANCE CORPORATION

Statement of Revenues, Expenses and Changes in Net Position

	Year Ended June 30, 2017	2016
Operating Revenues		
Gross direct written premiums	**$ 43,098,226**	$ 41,594,998
Change in unearned premiums	**297,259**	(188,250)
Total direct written premiums earned	**43,395,485**	41,406,748
Returned premiums	**(15,050,000)**	(12,295,000)
Net direct earned premiums	**28,345,485**	29,111,748
Ceded written premiums	**(950,226)**	(950,226)
Change in prepaid reinsurance	**1**	908
Total ceded written premiums expired	**(950,225)**	(949,318)
Net earned premiums	**27,395,260**	28,162,430
Total Operating Revenues	**27,395,260**	28,162,430
Operating Expenses		
Losses and loss adjustment expenses	**36,442,852**	36,760,393
Management fees	**58,521**	58,856
Premium tax	**95,784**	97,596
Other expenses	**118,031**	76,627
Total Operating Expenses	**36,715,188**	36,993,472
Operating loss	**(9,319,928)**	(8,831,042)
Nonoperating Revenues (Expenses)		
Net investment income (loss)	**17,840,031**	(1,036,293)
Total Nonoperating Revenues (Expenses)	**17,840,031**	(1,036,293)
Increase (decrease) in net position	**8,520,103**	(9,867,335)
Net Position, Beginning of Year	**48,042,337**	57,909,672
Net Position, End of Year	**$ 56,562,440**	$ 48,042,337

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

THE VERITAS INSURANCE CORPORATION

Statement of Cash Flows

	Year Ended June 30, 2017	2016
Cash Flows from Operating Activities		
Insurance premiums collected, net	**$ 30,803,226**	$ 25,623,644
Payments for losses and loss adjustment expenses	**(28,710,637)**	(31,443,318)
Payments for losses recoverable	**(621,588)**	(596,316)
Payments for net ceded reinsurance premiums	**(950,226)**	(950,226)
Payments for other expenses	**(162,552)**	(135,483)
Payments for premium tax	**(102,600)**	(87,551)
Net Cash Provided by (Used in) Operating Activities	**255,623**	(7,589,250)
Cash Flows from Investing Activities		
Proceeds from sales and maturities of investments	**61,999,657**	56,623,826
Purchases of investments	**(62,655,600)**	(49,435,120)
Investment income	**400,320**	400,544
Net Cash (Used in) Provided by Investing Activities	**(255,623)**	7,589,250
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 provided by (used in) operating activities:		
Operating loss	**$ (9,319,928)**	$ (8,831,042)
Adjustments to reconcile operating loss to net cash provided by (used in) operating activities:		
Changes in assets and liabilities:		
Losses receivable from the University	**(835,773)**	12,716
Premium tax recoverable	**(7,852)**	10,477
Prepaid premium tax	**1,036**	(432)
Prepaid reinsurance premiums	**(1)**	(908)
Reinsurance recoverable on paid losses	**214,185**	(609,033)
Reinsurance recoverable on unpaid losses	**104,535**	248,004
Reserves for losses and loss adjustment expenses	**7,124,556**	9,659,641
Return premiums payable to affiliated units	**2,755,000**	(3,676,354)
Unearned premium reserves	**(297,259)**	188,250
Losses payable and accrued liabilities	**517,124**	(4,590,569)
Net cash provided by (used in) operating activities	**$ 255,623**	$ (7,589,250)

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 2017 and 2016, 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.

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, 2017 and 2016. 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 rates used to discount reserves at June 30, 2017 and 2016 were 5 percent and 6 percent, respectively, which reflect 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 $15,050,000 and $12,295,000 were declared by the Board in 2017 and 2016, 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 LAE.

Reclassifications: Certain amounts previously presented within the operating and investing activities sections of the Statement of Cash Flows for the year ended June 30, 2016 have been revised to reflect the proper classification of this activity. Within the operating activities section, these revisions resulted in an increase in Payments for losses and loss adjustment expenses of $4,590,569, a decrease in Receipts for recoverable losses of $12,717 and a decrease in Net cash in transit for receipts and payments of $4,577,852. Within the investing activities section, these revisions resulted in a decrease in Purchases of investments of $6,306,296 and a decrease in Investment income of $6,306,296. There was no impact on amounts reported for net cash used in operating activities or net cash provided by investing activities for the year ended June 30, 2016.

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, 2017 and 2016 are summarized as follows:

	Amortized Cost	Unrealized Gains	Fair Value
June 30, 2017			
Cash equivalents	$ 250,000		$ 250,000
Daily and Monthly Portfolios	96,282,018	$ 4,655,593	100,937,611
Long Term Portfolio	99,954,443	16,191,730	116,146,173
	$ 196,486,461	$ 20,847,323	$ 217,333,784
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

Note 2--Cash and Investments--Continued

At June 30, 2017 and 2016, the Daily and Monthly Portfolios were comprised of 5 percent and 17 percent money market securities, 70 percent and 58 percent fixed income securities and the remaining 25 percent and 25 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, 99 percent were rated investment grade, and 72 percent consisted of U.S. Treasury and government agencies and non-U.S. government securities rated AAA/Aaa at June 30, 2017, compared to 98 percent and 71 percent, respectively, at June 30, 2016. 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 1.6 years at June 30, 2017, compared to 1.7 years at June 30, 2016.

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, 2017 and 2016, the Long Term Portfolio consisted of cash and equivalents (1 percent and 1 percent), fixed income securities (8 percent and 9 percent), U.S. and non-U.S. equities (12 percent and 14 percent), commingled funds (27 percent and 25 percent) and nonmarketable alternative investments (52 percent and 51 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 13 percent and 8 percent of the portfolio at June 30, 2017 and 2016, 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 fair market 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, 2017 and 2016 is summarized as follows:

	2017	2016
Reserves for losses and LAE, beginning of year	$ 136,246,333	$ 126,586,692
Less reinsurance recoverable on unpaid losses	1,072,936	1,320,939
Net reserves for losses and LAE, beginning of year	135,173,397	125,265,753
Add incurred losses and LAE related to:		
Current year	43,991,005	41,722,126
Prior years	(7,548,153)	(4,961,733)
Total incurred losses and LAE	36,442,852	36,760,393
Less paid losses and LAE related to:		
Current year	3,768,043	3,242,698
Prior years	25,445,717	23,610,051
Total paid losses and LAE	29,213,760	26,852,749
Net reserves for losses and LAE, end of year	142,402,489	135,173,397
Reinsurance recoverable on unpaid losses	968,400	1,072,936
Reserves for losses and LAE, end of year	143,370,889	136,246,333
Less current portion	46,728,790	43,102,964
	$ 96,642,099	$ 93,143,369

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 5 percent and 6 percent at June 30, 2017 and 2016, respectively.

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 $18,898,332 and $21,328,650 at June 30, 2017 and 2016, respectively.

In 2017, incurred losses and LAE related to policies incepted during the year increased $2,268,879. Incurred losses and LAE related to prior years decreased $7,548,153 due to net favorable loss development. Medical professional liability decreased $5,952,111 and property damage decreased $1,617,435, which was offset by a workers' compensation increase of $292,218. The remaining lines of coverage provided combined favorable development of $270,825. The net favorable development is primarily due to claims experience reporting lower than previously projected for recent prior policy years.

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 unfavorable development of $311,971. 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, 2017 and 2016, the University provided claims administration and risk management services, with an approximate value of $8,022,000 and $7,790,000, respectively, at no cost to the Corporation.

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 $15,050,000 and $12,295,000 at June 30, 2017 and 2016, 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, 2017 and 2016.

Unrestricted net position at June 30, 2017 and 2016 is summarized as follows:

	2017	**2016**
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	51,108,107	42,588,004
	$ 56,562,440	$ 48,042,337