# *Indiana Secondary Market for Education Loans, Inc.*

*Financial Statements and Supplemental Information for the Years Ended June 30, 2007 and 2006, and Independent Auditors' Report*

# INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

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## MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

The financial analysis discussion and overview of Indiana Secondary Market for Education Loans, Inc. ("ISM") is required supplementary information. Among other things, it provides an analytical overview of ISM's condensed financial information and should be read in conjunction with the financial statements and related notes that follow.

### Overview of Indiana Secondary Market for Education Loans, Inc.

ISM was established pursuant to Public Law No. 154 of the 1980 Indiana General Assembly and is a public benefit corporation organized exclusively for education purposes. ISM serves as the State of Indiana's designated secondary market for education loans and acts as an eligible lender under the Higher Education Act. ISM pursues its mission of enhancing access for Indiana residents pursuing education at post-secondary institutions by providing reduced cost loans and making direct loans for the purpose of consolidating all or a portion of a borrower's outstanding educations loans into one (1) loan.

ISM is currently governed by a seven member Board of Directors who are nominated by the Governor of the State of Indiana and elected by the remaining Directors. Taxable and tax-exempt bonds, note financings, and line of credit facilities are the primary sources of funding for ISM's programs. ISM administers a program for the purchase, origination and servicing of loans guaranteed and reinsured by the United States Department of Education ("US DOED") under the Federal Family Education Loan Program ("FFELP"). ISM's programs are designed to facilitate access for all Indiana residents to educational funding, primarily using federal student loans.

ISM's financial statements consist of the following: the statements of net assets, the statements of revenues, expenses and changes in net assets and the statements of cash flows. These financial statements are prepared in accordance with accounting principles generally accepted in the United States of America as promulgated by the Government Accounting Standards Board. The statements of net assets present the financial position of ISM at the end of the fiscal year and include all assets, liabilities and net assets of ISM. The statements of revenues, expenses and changes in net assets present ISM's results of operations and changes in its net assets for the years ended June 30, 2007 and 2006. The statements of cash flows provide information about the sources and uses of ISM's cash resources for the years ended June 30, 2007 and 2006.

# INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED, UNAUDITED)

### Condensed Financial Information (in thousands)

| **Financial Position** | **2007** | **2006** | **2005** |
|---|---|---|---|
| Cash and short-term investments | $ 104,614 | $ 193,027 | $ 71,223 |
| Student loans receivable—net | 1,680,417 | 1,288,564 | 506,155 |
| Other assets | 54,365 | 41,821 | 15,846 |
| Total assets | $ 1,839,396 | $ 1,523,412 | $ 593,224 |
| Lines of credit | $ 371,000 | $ 56,850 | $ 28,350 |
| Taxable bonds payable | 1,143,200 | 1,143,200 | 243,200 |
| Tax-exempt bonds payable | 231,650 | 234,650 | 240,650 |
| Other liabilities | 13,625 | 11,213 | 6,557 |
| Total liabilities | 1,759,475 | 1,445,913 | 518,757 |
| Total net assets | 79,921 | 77,499 | 74,467 |
| Total liabilities and net assets | $ 1,839,396 | $ 1,523,412 | $ 593,224 |
| **Operating Results** | | | |
| Interest on student loans | $ 54,604 | $ 27,620 | $ 11,920 |
| Special allowance on student loans | 37,838 | 23,940 | 14,457 |
| Interest income and other | 10,758 | 7,442 | 2,853 |
| Total operating revenues | 103,200 | 59,002 | 29,230 |
| Interest expense | 81,899 | 40,857 | 11,082 |
| Fees and debt issuance costs | 2,937 | 2,221 | 1,215 |
| Loan servicing and administration | 14,987 | 11,189 | 6,918 |
| Arbitrage rebate (recovery) provision | (1,040) | 1,195 | 3,271 |
| Distribution to the State of Indiana | 1,995 | 508 | |
| Total operating expenses | 100,778 | 55,970 | 22,486 |
| Change in net assets | $ 2,422 | $ 3,032 | $ 6,744 |

# INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

## MANAGEMENT'S DISCUSSION AND ANALYSIS (CONTINUED, UNAUDITED)

## Financial Analysis

### Financial Position

As of June 30, 2007, total assets increased $316 million compared to an increase in liabilities of $314 million resulting in an increase in ISM's net assets of $2.44 million or 3.12%. This increase compares to a related increase in net assets of 4.07% in fiscal 2006. This year to year decrease in the percentage of change in net assets is related to higher servicing and administration costs related to the increased scope of servicing activities discussed later.

Cash and cash equivalents decreased 46% to $105 million from $193 million in fiscal 2006, as compared to a 171% increase from $71 million in fiscal 2005 to fiscal 2006. The current year decrease in cash and cash equivalents is the result of the normal use cash to acquire loans and pay operating and debt service expenses. The prior year increase was attributable to the issuance of $500 million in student loan revenue bonds in May 2005 which resulted in a substantial cash balance at 2005 fiscal year end.

Student loans receivable increased 30% from $1,288 million in fiscal 2006 to $1,680 million in fiscal 2007 as compared to a 155% increase from $506 million in fiscal 2005 to fiscal 2006. During fiscal year 2007, ISM purchased/originated $787 million of gross principal loans from financial institutions and loan production partners. This compares with $958 million during fiscal year 2006 and $325 million during fiscal year 2005 which represents a 17% decrease and 198% increase in loans purchased from the previous two fiscal years. For fiscal year 2007, approximately $94 million of loans purchased were Stafford and PLUS loans, while gross Consolidation loan purchases totaled $693 million ($571 million representing volume provided by loan production partners).

The net loan activity less existing loan principal decreases through borrower, consolidation, claim payments, cancellation activity and loan sales resulted in an increase in the student loan portfolio of 30% from $1,288 million to $1,680 million from fiscal year 2006 to fiscal year 2007 as compared to a 155% increase from $506 million to $1,288 million from fiscal year 2005 to fiscal year 2006. As of June 30, 2007, the student loan portfolio held by ISM is made up of approximately 84% Consolidation Loans and 16% Stafford and PLUS Loans.

Other assets increased 30% from $42 million in fiscal 2006 to $54 million in fiscal 2007 as compared to a 243% increase from $15 million in fiscal 2005 to fiscal 2006. The majority of these increases relate to growth in interest receivable on increased balances in student loan receivables and cash. Interest receivable has also increased as a result of rising interest rates over the last three fiscal years. These increases were offset by a decrease in prepaids and other assets due to the servicing receivable decreasing as ISM now services approximately 95% of it portfolio as of June 30, 2007.

ISM finances the purchase of loans through the issuance of taxable and tax-exempt student loan revenue bonds and other forms of indebtedness. During fiscal year 2007, purchases were funded primarily from a $500 million taxable bond financing in late fiscal 2006 and $555 million in available borrowings under warehousing arrangements.

Beginning in fiscal 2006 and continuing into fiscal 2007, ISM utilized a conduit financing and revolving lines of credit to purchase loans. This strategy allows ISM to effectively warehouse loans and fully collateralize any subsequent permanent financing at the time of issuance or shortly thereafter. This method allows more flexibility and efficiency, and allows a better matching of collateral to a specific bond structure.

During fiscal year 2007, ISM maintained revolving credit facilities originally issued at $280 million and established a variable floating note (VFN) program originally sized at $250 million. At June 30, 2007, $224 million and $147 million respectively of the lines of credit and VFN program were outstanding. There were no bonds issued during the fiscal year ended June 30, 2007.

Warehouse funding sources (bank lines of credit and VFN) increased from $57 million at June 30, 2006 to $371 million at June 30, 2007. This net increase was the result of increased utilization of warehouse funding as a primary method to finance the purchase student loans. In addition, $3 million of scheduled principal repayments on tax-exempt bonds occurred in December 2006. No taxable or tax-exempt bonds were issued during fiscal year ended June 30, 2007.

Total net assets at June 30, 2007 were $80 million representing an increase of 3.12% from $78 million at June 30, 2006. This compared to a 4.07% increase in fiscal year 2006. Pursuant to Board resolutions on December 17, 2002 and April 22, 2003, ISM has designated $5.60 million for use in higher education enhancement related projects as defined by the Indiana Commission for the Higher Education. This amount is included in unrestricted net assets.

## Legislative Update

The College Cost Reduction and Access Act (the “CCRA”) was signed September 18, 2007 by the United State Senate and the House of Representatives and signed by the President on September 27, 2007. The CCRA is effective October 1, 2007. The CCRA reduces participating lender yields by cutting special allowance rates and increasing lender origination fees. Certain provisions will: (1) reduce special allowance payments on Stafford and consolidation loans by 0.40 percentage points, (2) reduce special allowance payments on Parental Loans for Undergraduate Students (PLUS) loans by 0.70 percentage points for tax-exempt lenders, (3) maintain default insurance at 97 percent, but eliminate the exceptional performer designation, and (4) increases lender paid origination fees by 0.50%.

### Operating Results

ISM's change in net assets was $2.44 million from operating revenues of $103 million for the fiscal year ended June 30, 2007, compared to a change in net assets of $3.03 million from operating revenues of $59 million for the prior fiscal year ended. The current year change in net assets was primarily due to a $391.85 million increase in the student loan portfolio and the interest and special allowance income earned related thereto. Additionally, interest expense on debt arrangements (lines of credit and bonds payable) increased resulting from increases in related interest rates and a general increase in the amounts outstanding.

Total operating revenues increased 75%, from $59 million for the fiscal year ended June 30, 2006, to $103 million for the fiscal year ended June 30, 2007. Total operating revenues increased 102% from $29 million for the fiscal year ended June 30, 2005, to $59 million for the fiscal year ended June 30, 2006. Interest on student loans increased 98% during the fiscal year ended June 30, 2007 due to the increase in ISM's student loan portfolio. The special allowance on student loans also increased during fiscal year 2007 from a higher general level of interest rates compared to the low fixed rate on recently acquired consolidation loans and the effect of significantly higher loan balances in ISM's portfolio.

Total operating expenses increased 80% from $56 million for the fiscal year ended June 30, 2006, to $101 million for the fiscal year ended June 30, 2007. Total operating expenses increased 149% from $22 million for the fiscal year ended June 30, 2005, to $56 million for the fiscal year ended June 30, 2006. This current year increase is directly related to an increase in loan servicing and administration expenses of $3.78 million incurred to support higher loan volumes and in-house loan servicing, the increase in interest expense on debt arrangements of $41.04 million resulting from both the increase in debt arrangements (lines of credit and bonds payable) and an increase in the related interest rates.

During the fiscal year 2007, ISM fulfilled a portion of its commitment to support higher education in the State of Indiana. For the past year, ISM has funded an initiative to provide electronic transcript transmission to facilitate the admission of incoming freshman at Indiana colleges and universities. During fiscal 2007, $495,000 of funding was provided for this effort. Also during the fiscal year, ISM transferred $1.5 million to the State of Indiana's education fund for STEM education and other projects.

### Loan Servicing

Starting in July 2006, ISM transferred responsibility for servicing its loan portfolio from American Education Services to the current servicing center located in Indianapolis, Indiana. As part of that transfer, certain costs were incurred for moving, infrastructure and labor. At the end of fiscal 2007, 94.21% of loans owned by ISM were serviced by ISM. Control of servicing quality and delivery, as well as long term cost savings were considerations in making this transition.

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## INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Indiana Secondary Market for Education Loans, Inc.
Indianapolis, Indiana

We have audited the accompanying statements of net assets of Indiana Secondary Market for Education Loans, Inc. ("ISM"), a component unit of the State of Indiana, as of June 30, 2007 and 2006, and the related statements of revenues, expenses, and changes in net assets and of cash flows for the years then ended. These financial statements are the responsibility of the management of ISM. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ISM's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of ISM as of June 30, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 1 to 5 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of ISM's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

Deloitte & Touche LLP

September 21, 2007

# INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

**STATEMENTS OF NET ASSETS**
**AS OF JUNE 30, 2007 AND 2006**
**(In thousands)**

| | 2007 | 2006 |
|---|---|---|
| **ASSETS** | | |
| CURRENT ASSETS: | | |
| Cash and short-term investments: | | |
| Unrestricted | $ 100,037 | $ 187,411 |
| Designated | 4,577 | 5,616 |
| Total cash and short-term investments | 104,614 | 193,027 |
| Student loans receivable — net | 65,663 | 48,158 |
| Accrued interest receivable — student loans receivable | 44,308 | 25,184 |
| Accrued interest receivable — cash and short-term investments | 415 | 833 |
| Prepaids and other assets | 1,812 | 7,546 |
| Total current assets | 216,812 | 274,748 |
| NON-CURRENT ASSETS: | | |
| Student loans receivable — net | 1,614,754 | 1,240,406 |
| Prepaids and other assets | 5,962 | 6,109 |
| Capital assets — net | 1,868 | 2,149 |
| Total long-term assets | 1,622,584 | 1,248,664 |
| TOTAL | $ 1,839,396 | $ 1,523,412 |
| **LIABILITIES AND NET ASSETS** | | |
| CURRENT LIABILITIES: | | |
| Lines of credit | $ 371,000 | $ 56,850 |
| Bonds payable | | 3,000 |
| Accounts payable and accrued expenses | 3,218 | 3,482 |
| Accrued interest payable | 5,830 | 2,115 |
| Total current liabilities | 380,048 | 65,447 |
| NON-CURRENT LIABILITIES: | | |
| Bonds payable | 1,374,850 | 1,374,850 |
| Arbitrage rebate payable | 4,577 | 5,616 |
| Total long-term liabilities | 1,379,427 | 1,380,466 |
| Total liabilities | 1,759,475 | 1,445,913 |
| NET ASSETS: | | |
| Invested in capital assets | 1,868 | 2,149 |
| Unrestricted | 73,476 | 69,734 |
| Restricted | 4,577 | 5,616 |
| Total net assets | 79,921 | 77,499 |
| TOTAL | $ 1,839,396 | $ 1,523,412 |

See notes to financial statements.

# INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

## STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
## FOR THE YEARS ENDED JUNE 30, 2007 AND 2006
## (In thousands)

| | 2007 | 2006 |
|---|---|---|
| OPERATING REVENUES: | | |
| Interest on student loans | $ 43,848 | $ 21,466 |
| U.S. Secretary of Education: | | |
| Special allowance | 37,838 | 23,940 |
| Interest subsidy | 10,756 | 6,154 |
| Interest income and other | 10,758 | 7,442 |
| Total operating revenues | 103,200 | 59,002 |
| OPERATING EXPENSES: | | |
| Interest expense | 81,899 | 40,857 |
| Fees and debt issuance costs | 2,937 | 2,221 |
| Loan servicing and administration | 14,986 | 11,189 |
| Arbitrage rebate (recovery) provision | (1,039) | 1,195 |
| Distributions to the State of Indiana | 1,995 | 508 |
| Total operating expenses | 100,778 | 55,970 |
| CHANGE IN NET ASSETS | 2,422 | 3,032 |
| NET ASSETS — Beginning of year | 77,499 | 74,467 |
| NET ASSETS — End of year | $ 79,921 | $ 77,499 |

See notes to financial statements.

# INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

## STATEMENTS OF CASH FLOWS
## FOR THE YEARS ENDED JUNE 30, 2007 AND 2006
## (In thousands)

| | 2007 | 2006 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Student loan interest and special allowance payments received | $ 73,318 | $ 36,952 |
| Purchase of student loans | (787,118) | (957,520) |
| Principal receipts on student loans | 284,913 | 192,910 |
| Cash received on sale of student loans | 139,510 | 14,700 |
| Cash payments for origination fees and premiums on student loans | (22,796) | (38,936) |
| Cash received for other operating activities | 6,923 | 7,521 |
| Cash payments for employees and vendors | (15,659) | (11,485) |
| Net cash used in operating activities | (320,909) | (755,858) |
| CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES: | | |
| Proceeds from issuance of bonds | | 900,000 |
| Proceeds from lines of credit | 350,000 | 284,000 |
| Repayment of bonds | (3,000) | (6,000) |
| Repayment of lines of credit | (35,850) | (255,500) |
| Payment of debt issuance costs | (253) | (3,362) |
| Interest paid on bonds | (78,185) | (39,829) |
| Net cash provided by noncapital financing activities | 232,712 | 879,309 |
| CASH FLOWS FROM CAPITAL ACTIVITIES: | | |
| Purchase of capital assets | (216) | (2,141) |
| Cash received for leasehold incentives | | 494 |
| Net cash provided by capital activities | (216) | (1,647) |
| CHANGE IN CASH AND SHORT-TERM INVESTMENTS | (88,413) | 121,804 |
| CASH AND SHORT-TERM INVESTMENTS — Beginning of year | 193,027 | 71,223 |
| CASH AND SHORT-TERM INVESTMENTS — End of year | $ 104,614 | $ 193,027 |

See notes to financial statements. (Continued)

# INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

## STATEMENTS OF CASH FLOWS
## FOR THE YEARS ENDED JUNE 30, 2007 AND 2006
## (In thousands)

| | 2007 | 2006 |
|---|---|---|
| RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH USED IN OPERATING ACTIVITIES: | | |
| Change in net assets | $ 2,422 | $ 3,032 |
| Adjustments to reconcile change in net assets to net cash used in operating activities: | | |
| Amortization of loan and bond charges | 9,291 | 5,876 |
| Depreciation on capital assets | 497 | 209 |
| Interest expense | 81,899 | 40,857 |
| Provision for allowance for loan losses | 900 | 586 |
| Arbitrage rebate (recovery) provision | (1,039) | 1,195 |
| Gain on sale of student loans | (4,071) | (401) |
| Other | | (1,269) |
| Change in assets and liabilities: | | |
| Increase in student loans receivable | (397,618) | (788,446) |
| Increase in accrued interest receivable | (18,580) | (15,283) |
| Decrease (increase) in prepaids and other assets | 6,151 | (5,675) |
| Increase (decrease) in other liabilities | (761) | 3,461 |
| Net cash used in operating activities | $ (320,909) | $ (755,858) |
| NONCASH OPERATING ACTIVITY — Capitalized interest and payment reapplications | $ 16,198 | $ 5,999 |

See notes to financial statements. (Concluded)

**1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Description of Business*** — Indiana Secondary Market for Education Loans, Inc. ("ISM" or the "Company") is a not-for-profit corporation formed to purchase and originate student loans under the Federal Family Education Loan Program ("FFELP") provided for by the Higher Education Act. Outstanding bonds are payable as specified in the resolutions authorizing the related sale of the bonds, are not payable by funds received from taxation, and are not debts of the State of Indiana or any of its political subdivisions. ISM is a major, discretely presented, proprietary component unit of the State of Indiana.

***Basis of Presentation and Accounting*** — ISM's financial statements have been prepared on the basis of the governmental enterprise fund concept which pertains to financial activities that operate similarly to a private business enterprise. The assets of each fund are restricted pursuant to the bond resolutions. For financial statement presentation purposes, the funds have been aggregated into one proprietary fund type. ISM's funds are accounted for on the flow of economic resources measurement focus and use the accrual basis of accounting. ISM applies all applicable Financial Accounting Standards Board pronouncements which do not conflict with Governmental Accounting Standards Board ("GASB") pronouncements.

***Student Loans Receivable*** — Student loans receivable are stated at the principal amount outstanding adjusted for an estimated allowance for loan losses, unamortized purchase premiums, and origination fees paid on behalf of banks and borrowers. The related interest income generated from student loans is offset by premium and origination fee amortization expenses. ISM amortizes loan premiums and loan origination fees over the estimated average life of the loan on a straight-line basis ranging from 4 to 10 years, which approximates the effective interest method.

Interest on student loans is accrued based upon the actual principal amount outstanding. The U.S. Secretary of Education makes quarterly interest subsidy payments until the student is required, under the provisions of the Higher Education Act, to begin repayment. Repayment must begin generally within six months after the student completes their course of study, leaves school, or ceases to carry at least one-half the normal full-time academic load as determined by the participating institution.

The U.S. Department of Education ("US DOED") provides a special allowance to lenders participating in the FFELP. For loans first disbursed prior to January 1, 2000, the special allowance amount is the result of applying a percentage, based upon the average bond equivalent rates of 91-day United States Treasury bills, to the average daily unpaid principal balance and capitalized interest of student loans held by the Company. For loans first disbursed from January 1, 2000, through June 30, 2006, the special allowance amount is the result of applying a percentage, based upon the average bond equivalent rates of the three-month financial Commercial Paper ("CP") rate, to the average daily unpaid principal balance and capitalized interest of student loans held by the Company. The special allowance is accrued as earned.

***Cash and Short-Term Investments*** — Cash and short-term investments are cash equivalents consisting of United States Treasury bills and money market mutual funds and Guaranteed Investment Contracts ("GICs"), which are carried at cost and approximate market, with an original maturity of less than 90 days. ISM is restricted to investments that meet the rating requirements per the bond indenture. At June 30, 2007 and 2006, all short-term investments are money market funds and GICs. All cash and short-term investments whose proceeds are designated for the payment of arbitrage rebate liabilities are classified as designated cash and short-term investments (see Note 3).

***Deposit and investment policies*** — ISM has not adopted a formal investment policy.

As of June 30, 2007, ISM had the following short-term investments and maturities:

| Investment Type | Fair Value (In thousands) | Investment Maturities (In Years) | | | |
|---|---|---|---|---|---|
| | | < 1 | 1–5 | 6–10 | > 10 |
| Guaranteed investment contracts | $ 4,421 | $ 4,421 | $ | $ | $ |
| Money market funds | 82,295 | 82,295 | | | |
| | $ 86,716 | $ 86,716 | $ | $ | $ |

The following table provides information on the credit ratings associated with ISM's short-term investments as of June 30, 2007.

| Investment Type | Fair Value (In thousands) | S & P | Fitch | Moody's |
|---|---|---|---|---|
| Guaranteed investment contracts | $ 4,421 | unrated | unrated | unrated |
| Money market funds | 82,295 | AAAm | | |
| | $ 86,716 | | | |

As of June 30, 2006, ISM had the following short-term investments and maturities:

| Investment Type | Fair Value (In thousands) | Investment Maturities (In Years) | | | |
|---|---|---|---|---|---|
| | | < 1 | 1– 5 | 6–10 | > 10 |
| Guaranteed investment contracts | $ 69,421 | $ 69,421 | $ | $ | $ |
| Money market funds | 120,010 | 120,010 | | | |
| | $ 189,431 | $ 189,431 | $ | $ | $ |

The following table provides information on the credit ratings associated with ISM's short-term investments as of June 30, 2006:

| Investment Type | Fair Value (In thousands) | S & P | Fitch | Moody's |
|---|---|---|---|---|
| Guaranteed investment contracts | $ 69,421 | unrated | unrated | unrated |
| Money market funds | 120,010 | AAAm | | |
| | $ 189,431 | | | |

Custodial risk is the risk that in the event of bank failure, ISM's deposits may not be returned to it. From time to time, certain short-term investment balances maintained by ISM exceed federally insured limits. As of June 30, 2007, ISM had cash and short-term investment balances of $104,414,000 with custodial risk.

***Allowance for Loan Losses*** — Guarantees on student loans originated after October 1, 1993, provide for a reduced recovery of 98% of loan principal and accrued interest on loans which default. Accordingly, ISM provides for an allowance for the estimated loss associated with the portion not recoverable. This allowance is increased by a provision charged to operations and reduced for losses actually incurred, and is included in the financial statements as a reduction of student loans receivable. At June 30, 2007 and 2006, the allowance for loan losses was $2,065,000 and $1,165,000, respectively.

In completing the analysis of the adequacy of the allowance for loan losses, past collection experience, delinquency trends and size of the portfolio, economic conditions, and other factors are considered. Significant changes in these factors could impact the allowance and provision for loan losses. A large percentage of ISM's loans have not matured to a point at which predictable loss patterns have developed. Accordingly, the evaluation of the allowance for loan losses is inherently subjective as it requires material estimates that may be subject to change.

***Debt Issuance Costs*** — Debt issue costs are amortized using a method that approximates the effective interest method over the terms of their respective agreements, ranging from 18 months to 40 years. Unamortized debt issue costs are included in prepaids and other assets and totaled $6,194,000 and $6,294,000 at June 30, 2007 and 2006, respectively.

***Capital Assets*** — Capital assets consist of office furniture, equipment and leasehold improvements recorded at cost. Depreciation is charged to operations on the straight-line method over the estimated useful lives of the related assets or the term of the lease, which is 3 to 7 years depending on the asset class.

***Net Assets*** — $73,476,000 and $69,734,000 of ISM's net assets and all related revenues are unrestricted at June 30, 2007 and 2006, respectively. ISM does, however, maintain debt and other arrangements which limit the use of assets as described in Note 3. In addition, pursuant to Board resolutions on December 17, 2002 and April 22, 2003, ISM has designated $5,600,000 ($7,100,000 as of June 30, 2006) for use in higher education enhancement related projects as defined by the Indiana Commission for the Higher Education. This amount is included in unrestricted net assets. At June 30, 2007 and 2006, ISM's restricted net assets of $4,577,000 and $5,616,000, respectively, reflect amounts restricted to fund the arbitrage rebate payable (see Note 6) and $1,868,000 and $2,149,000 reflect amounts invested in capital assets (see Note 5).

***Loan Income and Related Expenses*** — Interest and special allowance on loans are recognized as income in the period earned and servicing costs are charged to expense as incurred. Premiums paid for student loans and origination fees paid on behalf of banks and borrowers are amortized using a method which approximates the effective interest method over the estimated life of the loans (10 years). At June 30, 2007 and 2006, unamortized premiums totaled $46,856,000 and $36,362,000, respectively, and unamortized origination and default fees totaled $13,653,000 and $10,293,000, respectively, and are included in the financial statements as a component of student loans receivable.

***Servicing Fee*** — As of June 30, 2007, American Education Services, Nelnet Corporation, Sallie Mae Servicing, Affiliated Computer Services, and Great Lakes Education Loan Services service less than 5% of ISM's student loan portfolio. Servicing fee expense amounts are included in operating expenses in the statement of revenues and expenses and changes in net assets. In addition, ISM services 95% of the student loan portfolio and is charged servicing fees for the use of the AES Compass system.

***Risk Management*** — ISM is exposed to various risks of loss related to property loss, torts, errors and omissions, and employee injuries. Coverage for these various risks of loss is obtained through commercial insurance. There has been no significant reduction in insurance coverage from the prior year for all categories of risk. Commercial insurance is purchased in an amount that is sufficient to cover ISM's risk of loss. ISM will record an estimated loss from a claim as an expense and a liability if it meets the following requirements: (1) information available indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and (2) the amount of the loss can be reasonably estimated.

***Operating Revenues and Expenses*** — Bond and loan issuances are the principal source of the funds. ISM derives revenue from short-term investments, servicing fees, interest on student loans and the U.S. Secretary of Education. ISM's expenses primarily consist of interest on debt arrangements and loan servicing and administration.

***Income Taxes*** — The Company is a tax-exempt organization under the provisions of the Internal Revenue Code, Section 501(c)(3) and, accordingly, no provision for income taxes has been made in the accompanying financial statements.

***Use of Estimates*** — 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 the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates that are particularly susceptible to change in the near-term relate to the determination of the arbitrage rebate payable and the allowance for loan losses.

***Reclassifications*** — $508,000 of Distributions to the State of Indiana expense as previously reported in the 2006 Statement of Revenues, Expenses, and Changes in Net Assets has been reclassified to conform to the 2007 presentation.

## 2. STUDENT LOANS RECEIVABLE — NET

Student loans receivable consist of loans made under the Higher Education Act and are carried at their unpaid principal balance net of an allowance for loan losses plus unamortized purchase premiums, origination fees, and default fees. Student loans earn interest at various rates ranging from 4.70% to 10.00% depending upon the type of student loan and the date the student loan was made. Substantially all of the principal and accrued interest on student loans is insured by certain guarantee agencies which are reinsured by the federal government. At June 30, 2007 and 2006, the majority of ISM's student loans are guaranteed by the Pennsylvania Higher Education Assistance Agency (69% and 70% as of June 30, 2007 and 2006, respectively), California Student Aid Commission/EDFUND (15% and 6% as of June 30, 2007 and 2006, respectively), or United Student Aid Funds, Inc. (11% and 16% as of June 30, 2007 and 2006, respectively)

Student loans receivable, net as of June 30, 2007 and 2006, consist of the following:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Student loans | $1,621,973 | $1,243,074 |
| Purchase premiums, origination fees and other — net | 60,509 | 46,655 |
| Less — allowance for loan losses | (2,065) | (1,165) |
| | $1,680,417 | $1,288,564 |

## 3. BONDS PAYABLE

The following displays the aggregate changes in bonds payable for the fiscal years as of June 30, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Bonds payable — beginning of year | $1,377,850 | $ 483,850 |
| Proceeds | | 900,000 |
| Repayments | (3,000) | (6,000) |
| Bonds payable — end of year | $1,374,850 | $1,377,850 |

Bonds payable as of June 30, 2007 and 2006 consist of the following:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Education Loan Revenue Bonds — Series 1993 | $ | $ 3,000 |
| Auction Rate Certificates | 1,374,850 | 1,374,850 |
| | $1,374,850 | $1,377,850 |

The Education Loan Revenue Bonds issued in Series 1993 matured and were paid in full December 1, 2006.

Bonds payable at June 30, 2007 and June 30, 2006 include $1,143.20 million and $231.65 million of taxable and tax-exempt Auction Rate Certificates (“ARCs”), respectively. The ARCs mature on various dates between December 1, 2030 and May 1, 2046, respectively. Interest on the ARCs ranged from 3.55% to 5.50% and 2.50% to 5.50% during the years ended June 30, 2007 and 2006, respectively, and is payable either at each auction, which occurs every 28 or 35 days as stipulated in the related ARC agreement, or semiannually.

The following table displays scheduled debt maturities and contractual interest payments at June 30, 2007 (in thousands):

| Years Ending June 30 | Principal | Interest | Total |
|---|---|---|---|
| 2008 | $ | $ 60,985 | $ 60,985 |
| 2009 | | 60,985 | 60,985 |
| 2010 | | 60,985 | 60,985 |
| 2011 | | 60,985 | 60,985 |
| 2012 | | 60,985 | 60,985 |
| 2013–2017 | | 304,924 | 304,924 |
| 2018–2022 | | 304,924 | 304,924 |
| 2023–2027 | | 304,924 | 304,924 |
| 2028–2032 | 59,000 | 299,980 | 358,980 |
| 2033–2037 | 30,000 | 287,273 | 317,273 |
| 2038–2042 | 235,850 | 246,715 | 482,565 |
| 2043–2046 | 1,050,000 | 156,825 | 1,206,825 |
| Total | $1,374,850 | $2,210,490 | $3,585,340 |

Bonds of each series are secured by (a) the proceeds derived from the sale of the bonds, (b) eligible loans, and (c) certain accounts established by the respective bond resolutions, including monies and securities therein.

The respective bond resolutions establish the following special trust accounts for each bond series, unless otherwise indicated:

***Loan Accounts*** — The loan accounts are used to account for the proceeds of bond issues not required to be deposited in the debt service reserve accounts. Generally, amounts in the loan accounts may be expended (a) to finance eligible student loans, (b) to pay bond issue costs, and (c) to make deposits to the revenue accounts for the purpose of paying principal and/or interest on the bonds.

***Revenue Accounts*** — The revenue accounts are used to account for all revenues received by ISM. Generally, amounts in the revenue accounts are used (a) to make principal and/or interest payments on the bonds, (b) to fund debt service reserve accounts, (c) to pay estimated program expenses to the operating account, and (d) to reimburse the issuers of insurance guaranteeing the bonds for amounts borrowed under the terms of the policies. Excess amounts in the revenue account may be transferred to the loan accounts or to optional redemption accounts.

***Operating Accounts*** — Amounts deposited in operating accounts are used to pay reasonable and necessary program expenses for the bond issues.

***Rebate Accounts*** — Amounts deposited in the rebate accounts are used to pay the United States Treasury amounts required by Section 148 of the Internal Revenue Code.

Cash and short-term investments as of June 30, 2007 and 2006, consist of the following:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Special trust accounts: | | |
| Unrestricted: | | |
| Loan accounts | $ 61,498 | $ 155,654 |
| Revenue accounts | 8,083 | 6,036 |
| Designated — rebate accounts | 4,577 | 5,616 |
| Total special trust accounts | 74,158 | 167,306 |
| Operating account (includes $5,600 to the State of Indiana) | 30,456 | 25,721 |
| | $ 104,614 | $ 193,027 |

## 4. WAREHOUSING ARRANGEMENTS

ISM maintains credit and/or loan agreements ("Agreements") with KeyBank, N.A., First Indiana Bank, N.A., Bank of America, N.A., and UBS Real Estate Securities, Inc. The Agreements are collateralized by loans pledged under the Agreements and certain cash balances and contain certain financial and restrictive covenants. ISM was in compliance with all financial covenants as of June 30, 2007.

On August 8, 2005, ISM renewed the Agreement with Key Bank, N.A. through June 30, 2007 and increased the maximum amount available for borrowings from $50,000,000 to $75,000,000. Interest on this line of credit is charged based on LIBOR plus the applicable margin, and at June 30, 2007 and 2006, this line of credit balance was $0 and $26,850,000, respectively.

On August 16, 2006, ISM renewed the Agreement with Bank of America, N.A. through August 15, 2007. Interest on this line of credit is charged based on LIBOR plus the applicable margin, and at June 30, 2006, ISM did not have any outstanding borrowings on the line of credit. As of June 30, 2007 this line of credit balance was $200,000,000.

On March 27, 2007 the Agreement with First Indiana Bank, N.A. was renewed through March 31, 2008. Interest is charged based on LIBOR plus the applicable margin, and at June 30, 2007 and 2006, this line of credit balance was $24,000,000 and $30,000,000 respectively.

On August 23, 2006, ISM entered into a loan agreement with UBS Real Estate Securities, Inc. that allowed borrowings up to a maximum of $250,000,000 through August 21, 2007. On August 14, 2007, the agreement was renewed through August 19, 2008 and increased the allowed borrowings to a maximum of $300,000,000. Interest is charged based on LIBOR plus the applicable margin, and at June 30, 2007 this loan balance was $147,000,000.

The following table displays the aggregate changes in line of credit borrowings for fiscal years ended June 30, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Lines of credit — beginning of year | $ 56,850 | $ 28,350 |
| Proceeds | 350,000 | 284,000 |
| Repayments | (35,850) | (255,550) |
| Lines of credit — end of year | $ 371,000 | $ 56,850 |

## 5. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2007 (in thousands) is as follows:

| | Beginning Balance | Additions | Retirements | Ending Balance |
|---|---|---|---|---|
| Depreciable capital assets: | | | | |
| Furniture and equipment | $1,944 | $ 214 | $ | $2,158 |
| Leasehold improvements | 494 | 2 | | 496 |
| Total depreciable capital assets | 2,438 | 216 | | 2,654 |
| Less accumulated depreciation | 289 | 497 | | 786 |
| Net depreciable capital assets | $2,149 | $(281) | $ | $1,868 |

Capital asset activity for the year ended June 30, 2006 (in thousands) is as follows:

| | Beginning Balance | Additions | Retirements | Ending Balance |
|---|---|---|---|---|
| Depreciable capital assets: | | | | |
| Furniture and equipment | $355 | $ 1,647 | $ (58) | $ 1,944 |
| Leasehold improvements | 57 | 494 | (57) | 494 |
| Total depreciable capital assets | 412 | 2,141 | (115) | 2,438 |
| Less accumulated depreciation | 126 | 209 | (46) | 289 |
| Net depreciable capital assets | $286 | $ 1,932 | $ (69) | $ 2,149 |

## 6. ARBITRAGE REBATE PAYABLE

In accordance with Section 148 of the Internal Revenue Code of 1986 (the “Code”), as amended, and the regulations promulgated thereunder, ISM is required to pay to the United States Treasury certain amounts related to the ISM tax-exempt bond issues. The amount required to be paid represents the excess of amounts earned over the interest cost of the tax-exempt borrowings as defined in the Code. Non-purpose rebate payments are due every fifth year and when the bonds are retired. Purpose rebate payments are due every tenth year and every fifth year thereafter during the life of each bond issue and when the bonds are retired. The rebate calculation utilizes various assumptions and allows for the selection of alternative calculation options under the Code. At June 30, 2007 and 2006, the estimated arbitrage rebate liability is $4,577,000 and $5,616,000, respectively, which has been provided for in the financial statements. The factors used in determining this estimate are sensitive to change in the future and the change in estimate may be material to the financial statements. However, the ultimate amount payable, if any, is dependent on the investment yields and bond rates in the future.

The following table displays the aggregate changes in the arbitrage rebate payable during the fiscal years ended June 30, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Arbitrage rebate payable — beginning of year | $ 5,616 | $ 4,421 |
| (Recovery) provision | (1,039) | 1,195 |
| Ending balance | $ 4,577 | $ 5,616 |

## 7. FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value amounts have been determined by ISM using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts ISM could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The estimated fair values of ISM's financial instruments as of June 30, 2007 and 2006, are as follows:

| | 2007 | |
|---|---|---|
| | Carrying Amount | Estimated Fair Value |
| | (In thousands) | |
| ASSETS: | | |
| Cash and short-term investments | $ 104,614 | $ 104,614 |
| Student loans receivable — net | 1,680,417 | 1,730,828 |
| Accrued interest receivable | 44,723 | 44,723 |
| LIABILITIES: | | |
| Bonds payable | 1,374,850 | 1,358,210 |
| Lines of credit | 371,000 | 371,000 |
| Accrued interest payable | 5,830 | 5,830 |

| | 2006 | |
|---|---|---|
| | Carrying Amount | Estimated Fair Value |
| | (In thousands) | |
| ASSETS: | | |
| Cash and short-term investments | $ 193,027 | $ 193,027 |
| Student loans receivable — net | 1,288,564 | 1,333,907 |
| Accrued interest receivable | 26,017 | 26,017 |
| LIABILITIES: | | |
| Bonds payable | 1,377,850 | 1,329,468 |
| Lines of credit | 56,850 | 56,850 |
| Accrued interest payable | 2,115 | 2,115 |

***Cash and Short-Term Investments*** — Cash and short-term investments are carried at cost, which approximates fair value.

***Student Loans Receivable — Net*** — Loans are categorized by status (in-school, grace, repayment, and delinquent). The fair value is estimated by discounting the future cash flows using current rates of return required by investors in similar assets, less an estimated allowance for credit losses.

***Accrued Interest Receivable*** — Accrued interest receivable is carried at cost, which approximates fair value.

***Bonds Payable*** — For fixed-rate bonds, fair value was calculated based on quoted current market prices of the bonds. For variable rate bonds, the carrying amount is a reasonable estimate of its fair value.

***Lines of Credit*** — For line of credit borrowings, the carrying amount is a reasonable estimate of its fair value.

***Accrued Interest Payable*** — Accrued interest payable is carried at cost, which approximates fair value.

## 8. RETIREMENT PLANS

ISM established the Indiana Secondary Market 401(k) Retirement Plan (“Plan”) in July 2002. The Plan is a “Safe Harbor 401(k) Plan” as described in the Internal Revenue Code. All employees 18 or older are eligible to participate on the first day of the month following their hire date. ISM also may contribute a discretionary profit sharing benefit if the participants are employed at the end of the Plan year. ISM also matches participant contributions for an amount equal to 100% of participant contributions to a maximum of 4% of the participant’s annual earnings as the Safe Harbor contribution. Participants vest in ISM contributions 100% after one year of service. ISM’s contributions to the Plan during fiscal years 2007 and 2006 were approximately $423,000 and $175,000, respectively. The employees of ISM contributed approximately $267,000 and $166,000 to the Plan during fiscal years 2007 and 2006, respectively.

ISM established a Top Hat 457 Plan for certain officers of ISM in December 2006. Pursuant to the plan document, benefits are paid upon separation of service from ISM. ISM’s contributions to the Plan during fiscal year 2007 were $37,500.

## 9. COMMITMENT

ISM leases office space under the terms of a non-cancellable operating lease. Future minimum lease payments under this operating lease at June 30, 2007, are as follows:

| Years Ending June 30 | |
|---|---|
| 2008 | $ 365,000 |
| 2009 | 371,000 |
| 2010 | 376,000 |
| 2011 | 382,000 |
| 2012 | 388,000 |
| Thereafter | 1,401,000 |
| | $3,283,000 |

Lease expense under this operating lease was approximately $294,000 and $202,000 for the fiscal years ended June 30, 2007 and 2006, respectively.

## 10. SUBSEQUENT EVENTS

On July 10, 2007, ISM agreed to an amendment to a lease agreement dated November 4, 2005 resulting in additional annual rent expense of approximately $180,000.

At a regular meeting of the Board of Directors on July 17, 2007 a motion was passed to fund $2,000,000 in state education projects.

On August 28, 2007, ISM sold $18,500,000 of student loans and recognized a gain on the sale of these loans.

The College Cost Reduction and Access Act (the "CCRA") was signed September 18, 2007 by the United State Senate and the House of Representatives and signed by the President on September 27, 2007. CCRA is effective October 1, 2007. The CCRA reduces participating lender yields by cutting special allowance rates and increasing lender origination fees. Certain provisions will: (1) reduce special allowance payments on Stafford and consolidation loans by 0.40 percentage points, (2) reduce special allowance payments on Parental Loans for Undergraduate Students (PLUS) loans by 0.70 percentage points for tax-exempt lenders, (3) maintain default insurance at 97 percent, but eliminate the exceptional performer designation, and (4) increases lender paid origination fees by 0.50%.

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