Indiana Secondary Market for Education Loans, Inc.

Financial Statements and Supplemental Information for the Years Ended June 30, 2009 and 2008, and Independent Auditors' Report

KATZ, SAPPER & MILLER
Certified Public Accountants

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

TABLE OF CONTENTS

KATZ, SAPPER & MILLER

Katz, Sapper & Miller, LLP
Certified Public Accountants

800 East 96th Street
Suite 500
Indianapolis, IN 46240

Tel 317.580.2000
Fax 317.580.2117

Independent Auditors' Report

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

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, 2009 and 2008, and the related statements of revenues, expenses and changes in net assets and 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 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ISM at June 30, 2009 and 2008, 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.

The Management's Discussion and Analysis presented on pages 2-5 is not a required part of the basic financial statements, but is supplemental information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquires of management regarding the methods of measurement and presentation of the supplemental information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 15, 2009, on our consideration of ISM's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Katz, Sapper & Miller, LLP

Indianapolis, Indiana
October 15, 2009

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

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 nine 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. In addition, ISM supports Indiana resident's pursuit of access by providing informational presentations and distributing educational materials related to education funding.

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, 2009 and 2008. The statements of cash flows provide information about the sources and uses of ISM's cash resources for the years ended June 30, 2009 and 2008.

Condensed Financial Information (in thousands)

Financial Position	2009	2008	2007
Cash and short-term investments	$ 71,436	$ 88,313	$ 104,614
Student loans receivable—net	1,749,474	1,864,607	1,680,417
Other assets	47,898	50,506	54,365
Total assets	$ 1,868,808	$ 2,003,426	$ 1,839,396
Lines of credit			$ 371,000
Taxable bonds payable	$ 1,538,700	$ 1,693,200	1,143,200
Tax-exempt bonds payable	231,650	231,650	231,650
Other liabilities	12,829	9,797	13,625
Total liabilities	1,783,179	1,934,647	1,759,475
Total net assets	85,629	68,779	79,921
Total liabilities and net assets	$ 1,868,808	$ 2,003,426	$ 1,839,396

Operating Results	2009	2008	2007
Interest on student loans	$ 65,354	$ 72,721	$ 54,604
Special allowance on student loans	(14,975)	19,282	37,838
Interest income and other	14,659	3,590	10,758
Total operating revenues	65,038	95,593	103,200
Interest expense	36,452	88,792	81,899
Fees and debt issuance costs	2,670	3,258	2,937
Loan servicing and administration	8,579	15,537	14,987
Arbitrage rebate (recovery) provision	487	(1,030)	(1,040)
Distribution to the State of Indiana		178	1,995
Total operating expenses	48,188	106,735	100,778
Change in net assets	$ 16,850	$ (11,142)	$ 2,422

Financial Analysis

Financial Position

As of June 30, 2009, total assets decreased $135 million and combined with a decrease in liabilities of $151 million, this resulted in an increase to ISM's net assets of $17 million or 24%. This compares to a decrease from the prior year in net assets of 14% in fiscal 2008. This increase in net assets can be attributed to reduced operating costs from the previous fiscal year due to restructuring and outsourcing loan servicing as well as gains from bond tenders.

Cash and short-term investments decreased 19% to $71 million in fiscal 2009 from $88 million in fiscal 2008, as compared to a 16% decrease to $88 million from $105 million in fiscal 2007. The decreases in cash and short-term investments are the result of the bond tenders in the amount of $140 million and the normal use of cash to acquire loans and pay operating and debt service expenses.

Student loans receivable decreased 6% from $1,865 million in fiscal 2008 to $1,749 million in fiscal 2009, as compared to an 11% increase from $1,680 million in fiscal 2007 to $1,865 million in fiscal 2008. During fiscal year 2009, ISM discontinued purchasing or originating FFEL program loans due to the College Cost Reduction and Access Act (the "CCRAA") and challenges in the capital markets. However, ISM did participate in a spot loan purchase of consolidation loans being serviced at ACS.

The decrease in student loans receivable was also due to existing loan principal decreases through borrower, consolidation, claim and cancellation payment activity. As of June 30, 2009, the student loan portfolio held by ISM was made up of approximately 88% Consolidation Loans and 12% Stafford and PLUS Loans.

Other assets decreased 5% from $51 million in fiscal 2008 to $48 million in fiscal 2009, as compared to a 6% decrease from $54 million in fiscal 2007 to $51 million in fiscal 2008. The majority of these decreases relate to lower special allowance rates and lower return on investments.

ISM finances the purchase of loans through the issuance of taxable and tax-exempt student loan revenue bonds and other forms of indebtedness. There were no new financings during fiscal year 2009. During fiscal year 2008, purchases were funded primarily from a $550 million taxable bond financing in November, 2007.

During fiscal year 2008, ISM issued $550 million of taxable Auction Rate Certificates. 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. As of June 30, 2008, all lines of credit were closed and terminated.

Total net assets at June 30, 2009 were $86 million, representing an increase of 24% from $69 million at June 30, 2008. This compared to a 14% decrease in fiscal year 2008.

Operating Results

ISM's net assets increased $16.85 million on operating revenues of $65.04 million for the fiscal year ended June 30, 2009, compared to a decrease in net assets of $11.14 million from operating revenues of $95.59 million for the prior fiscal year. The current year change in net assets was primarily due to successful bond tenders resulting in a gain of $14.97 million, as well as a drop in interest rate indexes resulting from the deterioration in global credit during the fiscal year. As a result of the decrease in interest rates, interest earned on the student loan portfolio decreased. In addition, interest expense decreased by $52.34 million from the previous year. The market for ISM's student loan auction securities was disrupted for the fiscal year, with auctions ultimately failing on or around February 14, 2008, and bond interest reverting to the Maximum Auction Rate. This disruption has continued for all of 2009.

Total operating revenues decreased 32%, from $95.59 million for the fiscal year ended June 30, 2008, to $65.04 million for the fiscal year ended June 30, 2009. Total operating revenues decreased 7%, from $103.20 million for the fiscal year ended June 30, 2007, to $95.59 million for the fiscal year ended June 30, 2008. Interest income on student loans decreased 10% during the fiscal year ended June 30, 2009 due to the reduction in the size of the portfolio as well as a drop in interest rate indexes. The special allowance on student loans decreased during fiscal year 2009 from a lower general level of interest rates compared to the fixed rate on loans in ISM's portfolio.

Total operating expenses decreased 55% from $106.74 million for the fiscal year ended June 30, 2008, to $48.19 million for the fiscal year ended June 30, 2009. Total operating expenses increased 5.91% from $100.78 million for the fiscal year ended June 30, 2007, to $106.74 million for the fiscal year ended June 30, 2008. This current year decrease is directly related to the outsourcing of student loan servicing, restructuring of the organization and the decrease in interest expense on debt arrangements by $52 million.

Loan Servicing and ISM's Loan Purchase Programs

Margin stress created by the current environment has required ISM to review its business model with the goal of achieving cost savings and improving the efficiency with which ISM delivers its mission. Starting in July 2008, ISM transferred responsibility for servicing its loan portfolio to American Education Services from the servicing center located in Indianapolis, Indiana. As part of that transfer, certain costs were incurred for moving, infrastructure and labor. The transfer was completed in July 2008.

Recent Developments

ISM received a letter dated February 6, 2009, from the Department of Education regarding activities performed by Collegiate Risk Management. This is a student loan marketing agent associated with an ISM strategic partner. A preliminary ruling was made and ISM is in the process of appealing this ruling.

On July 15, 2009, the Student Aid and Fiscal Responsibility Act of 2009 (H.R. 3221) was introduced which amends the Higher Education Act of 1965. If this Act passes it will eliminate the FFEL program and move all loan origination to the Federal Direct program.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF NET ASSETS
AS OF JUNE 30, 2009 AND 2008
(In thousands)

	2009	2008
ASSETS		
CURRENT ASSETS:		
Cash and short-term investments:		
Unrestricted	$ 56,780	$ 73,217
Designated	4,034	3,547
Restricted	10,622	11,549
Total cash and short-term investments	71,436	88,313
Student loans receivable — net	80,358	80,429
Accrued interest receivable — student loans receivable	36,912	40,413
Accrued interest receivable — cash and short-term investments	4	121
Prepaids and other assets	2,602	31
Total current assets	191,312	209,307
NON-CURRENT ASSETS:		
Student loans receivable — net	1,669,116	1,784,178
Prepaids and other assets	7,422	8,210
Capital assets — net	958	1,731
Total non-current assets	1,677,496	1,794,119
TOTAL	$ 1,868,808	$ 2,003,426
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 8,338	$ 4,827
Accrued interest payable	457	1,423
Total current liabilities	8,795	6,250
NON-CURRENT LIABILITIES:		
Bonds payable	1,770,350	1,924,850
Arbitrage rebate payable	4,034	3,547
Total non-current liabilities	1,774,384	1,928,397
Total liabilities	1,783,179	1,934,647
NET ASSETS:		
Invested in capital assets	958	1,731
Unrestricted	70,015	51,952
Restricted	14,656	15,096
Total net assets	85,629	68,779
TOTAL	$ 1,868,808	$ 2,003,426

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, 2009 AND 2008
(In thousands)

	2009	2008
OPERATING REVENUES:		
Interest on student loans	$ 53,592	$ 59,892
U.S. Secretary of Education:		
Special allowance	(14,975)	19,282
Interest subsidy	11,762	12,829
Interest income and other	14,659	3,590
Total operating revenues	65,038	95,593
OPERATING EXPENSES:		
Interest expense	36,452	88,792
Fees and debt issuance costs	2,670	3,258
Loan servicing and administration	8,579	15,537
Arbitrage rebate/(recovery) provision	487	(1,030)
Distributions to the State of Indiana		178
Total operating expenses	48,188	106,735
CHANGE IN NET ASSETS	16,850	(11,142)
NET ASSETS — Beginning of year	68,779	79,921
NET ASSETS — End of year	$ 85,629	$ 68,779

See notes to financial statements.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2009 AND 2008
(In thousands)

	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Student loan interest and special allowance payments received	$ 50,427	$ 84,458
Purchase of student loans	(20,677)	(405,249)
Principal receipts on student loans	161,461	194,233
Cash received on sale of student loans		61,566
Cash payments for origination fees and premiums on student loans, net of refunding	1,716	(9,958)
Cash received for other operating activities	891	3,820
Cash payments for employees and vendors	(6,517)	(28,684)
Net cash provided (used) in operating activities	187,301	(99,814)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Proceeds from issuance of bonds		550,000
Proceeds from lines of credit		241,000
Repayment and redemption of bonds	(168,075)	
Repayment of lines of credit		(612,000)
Payment of debt issuance costs, net of refunding	576	(2,097)
Interest paid on bonds	(37,418)	(93,198)
Net cash provided (used) by noncapital financing activities	(204,917)	83,705
CASH FLOWS FROM CAPITAL ACTIVITIES:		
Sale (purchase) of capital assets	739	(380)
Cash received for leasehold incentives		188
Net cash provided (used) by capital activities	739	(192)
CHANGE IN CASH AND SHORT-TERM INVESTMENTS	(16,877)	(16,301)
CASH AND SHORT-TERM INVESTMENTS — Beginning of year	88,313	104,614
CASH AND SHORT-TERM INVESTMENTS — End of year	$ 71,436	$ 88,313

See notes to financial statements. (Continued)

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2009 AND 2008
(In thousands)

	2009	2008
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED (USED) IN OPERATING ACTIVITIES:		
Change in net assets	$ 16,850	$ (11,142)
Adjustments to reconcile change in net assets to net cash provided (used) in operating activities:		
Amortization of loan and bond charges	8,775	10,023
Depreciation on capital assets		551
Interest expense	36,452	88,792
Provision for allowance for loan losses	60	900
Arbitrage rebate/(recovery) provision	487	(1,030)
Loss on sale of student loans		601
Change in assets and liabilities:		
Decrease (increase) in student loans receivable	106,521	(194,824)
Decrease in accrued interest receivable	3,618	4,189
Decrease in prepaids and other assets	11,027	1,856
Increase in other liabilities	3,511	270
Net cash provided (used) in operating activities	$ 187,301	$ (99,814)

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 non-profit corporation formed to purchase and originate student loans under the Federal Family Education Loan Program ("FFELP") provided for by the Higher Education Act ("the 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.

The impacts of College Cost Reduction and Access Act (the "CCRAA") and current challenges related to the capital markets have necessitated changes in how ISM's business operates and in how ISM approaches loan servicing in general. Margin stress created by the current environment has required ISM to review its business model with the goal of achieving cost savings and improving the efficiency with which ISM can accomplish its mission. ISM is no longer originating FFELP loans. As of July 2008, ISM transferred responsibility for servicing its loan portfolio to American Education Services from the servicing center located in Indianapolis, Indiana.

ISM's bonds payable mature between 2030 and 2047. ISM's ability to meet its long-term obligations is dependent on borrowing costs, Department of Education subsidies and the ability to control operating expenses. Management has determined that obligations will be paid as due.

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 or discounts, 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, loan discounts and loan origination fees over the estimated average life of the loan on a straight-line basis over 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. If a special allowance amount is a negative number on a loan first disbursed prior to April 1, 2006, special allowance will not be paid for that loan type for that quarter. If a special allowance amount is a negative number on a loan first disbursed after April 1, 2006, the lender must remit the excess interest ("negative SAP") to the US DOED. The special allowance amount for a loan first disbursed on or after October 1, 2007, has additional provisions for lenders qualified as an eligible not-for-profit holder. Those eligible as not-for-profit lenders earn a 15 basis point higher yield. 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, 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, 2009 and 2008, all short-term investments were 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 4).

As of June 30, 2009, 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	$ 10,622	$ 10,622	$	$	$
Money market funds	39,066	39,066			
	$ 49,688	$ 49,688	$	$	$

The following table provides information on the credit ratings associated with ISM's short-term investments as of June 30, 2009.

Investment Type	Fair Value (In thousands)	S & P	Fitch	Moody's
Guaranteed investment contracts	$ 10,622	AA+	unrated	Aa2
Money market funds	39,066	AAAm	unrated	Aaa
	$ 49,688			

As of June 30, 2008, 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	$ 14,070	$ 14,070	$	$	$
Money market funds	52,610	52,610			
	$ 66,680	$ 66,680	$	$	$

The following table provides information on the credit ratings associated with ISM's short-term investments as of June 30, 2008:

Investment Type	Fair Value (In thousands)	S & P	Fitch	Moody's
Guaranteed investment contracts	$ 14,070	unrated	unrated	unrated
Money market funds	52,610	AAAm	unrated	Aaa
	$ 66,680			

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, 2009, ISM had cash and short-term investment balances of $71,227,000 with custodial risk. There are no limits on the amount that may be invested in any one financial institution or intermediary. The following shows an investment in an issuer that represents 5% or more of the total investments at June 30, 2009:

GE Funding Capital Market Services	21%
Wells Fargo Advantage Money Market	79%

Allowance for Loan Losses — Guarantees on student loans originated after October 1, 1993 but before July 1, 2006, provide for a reduced recovery of 98% of loan principal and accrued interest on loans which default. Guarantees on student loans originated after July 1, 2006 provide for a reduced recovery of 97% 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, 2009 and 2008, the allowance for loan losses was $3,025,000 and $2,965,000, 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 $7,201,000 and $8,001,000 at June 30, 2009 and 2008, 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 — $70,015,000 and $51,952,000 of ISM's net assets and all related revenues were unrestricted at June 30, 2009 and 2008, respectively. ISM does, however, maintain debt and other arrangements which limit the use of assets. At June 30, 2009 and 2008, ISM's restricted net assets of $10,622,000 and $11,549,000 per bond reserve requirements (see Note 3) and $4,034,000 and $3,547,000 reflect amounts restricted to fund the arbitrage rebate payable (see Note 6) and $958,000 and $1,731,000 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, 2009 and 2008, unamortized premiums totaled $40,099,000 and $46,578,000, respectively, and unamortized origination and default fees totaled $12,265,000 and $14,155,000, respectively, and are included in the financial statements as a component of student loans receivable. In addition, loans were purchased at a discount in June, 2009 and this discount is being amortized over the estimated life of the loans (10 years). At June 30, 2009, the unamortized discount totaled $1,898,000.

Servicing Fee — As of June 30, 2009, American Education Services, Nelnet Corporation, Sallie Mae Servicing, Affiliated Computer Services, and Great Lakes Education Loan Services service 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.

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, sublease rents, 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 — ISM 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.

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 3.61% 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, 2009 and 2008, the majority of ISM's student loans were guaranteed by the Pennsylvania Higher Education Assistance Agency (72% as of June 30, 2009 and 2008), California Student Aid Commission/EDFUND (15% and 14% as of June 30, 2009 and 2008, respectively), or United Student Aid Funds, Inc. (8% and 9% as of June 30, 2009 and 2008, respectively).

Student loans receivable, net as of June 30, 2009 and 2008, consisted of the following:

	2009	2008
	(In thousands)	
Student loans	$ 1,702,034	$ 1,806,838
Purchase premiums, discounts origination fees and other — net	50,465	60,734
Less — allowance for loan losses	(3,025)	(2,965)
	$ 1,749,474	$ 1,864,607

3. BONDS PAYABLE

The following displays the aggregate changes in bonds payable for the fiscal years ended June 30, 2009 and 2008:

	2009	2008
	(In thousands)	
Bonds payable — beginning of year	$ 1,924,850	$ 1,374,850
Proceeds		550,000
Repayments	(154,500)	
Bonds payable — end of year	$ 1,770,350	$ 1,924,850

Bonds payable as of June 30, 2009 and 2008 consisted of the following:

	2009	2008
	(In thousands)	
Auction Rate Certificates	$ 1,770,350	$ 1,924,850

Bonds payable at June 30, 2009 include $1,538.70 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, 2047. Interest on the ARCs ranged from .00% to 14.0% and 1.05% to 14.0% during the years ended June 30, 2009 and 2008, respectively, and was payable either at each auction, which generally occurs every 28 or 35 days as stipulated in the related ARC agreement, or semiannually. The interest rates are reset via a "dutch auction." Since February 2008, the auction process to establish these rates has failed; thus the ARCs will generally pay interest to the holder at a maximum rate as defined by the indenture. This failure also resulted in auctions occurring every 7 days.

The following table displays scheduled debt maturities and contractual interest payments for bonds payable at June 30, 2009 (in thousands):

Years Ending June 30	Principal	Interest	Total
2010	$	$ 115,669	$ 115,669
2011		115,669	115,669
2012		115,669	115,669
2013		115,669	115,669
2014		115,669	115,669
2015–2019		578,344	578,344
2020–2024		578,344	578,344
2025–2029		578,344	578,344
2030–2034	59,000	561,587	620,587
2035–2039	265,450	521,466	786,916
2040–2044	147,400	440,643	588,043
2045–2049	1,298,500	130,651	1,429,151
Total	$1,770,350	$3,967,724	$5,738,074

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.

4. CASH AND SHORT-TERM INVESTMENTS

Cash and short-term investments as of June 30, 2009 and 2008, consisted of the following:

	2009	2008
	(In thousands)	
Special trust accounts:		
Unrestricted:		
Loan accounts	$ 32,686	$ 42,187
Revenue accounts	2,346	8,235
Designated — rebate accounts	4,034	3,547
	39,066	53,969
Restricted:		
Reserve accounts	10,622	11,549
Operating account	21,748	22,795
	$ 71,436	$ 88,313

5. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2009 (in thousands) was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Depreciable capital assets:				
Furniture and equipment	$ 2,304	$ 24	$ 775	$ 1,553
Leasehold improvements	729	12		741
Total depreciable capital assets	3,033	36	775	2,294
Less accumulated depreciation	1,302	518	484	1,336
Net depreciable capital assets	$ 1,731	$ (482)	$ 291	$ 958

Capital asset activity for the year ended June 30, 2008 (in thousands) was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Depreciable capital assets:				
Furniture and equipment	$2,158	$ 209	$ 63	$2,304
Leasehold improvements	496	233		729
Total depreciable capital assets	2,654	442	63	3,033
Less accumulated depreciation	786	551	35	1,302
Net depreciable capital assets	$1,868	$(109)	$ 28	$1,731

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, 2009 and 2008, the estimated arbitrage rebate liability was $4,034,000 and $3,547,000, 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, 2009 and 2008:

	2009	2008
	(In thousands)	
Arbitrage rebate payable — beginning of year	$ 3,547	$ 4,577
(Recovery) provision	487	(1,030)
Ending balance	$ 4,034	$ 3,547

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, 2009 and 2008, were as follows:

	2009	
	Carrying Amount	Estimated Fair Value
	(In thousands)	
ASSETS:		
Cash and short-term investments	$ 71,436	$ 71,436
Student loans receivable — net	1,749,474	1,719,082
Accrued interest receivable	36,916	36,916
LIABILITIES:		
Bonds payable	1,770,350	1,635,360
Accrued interest payable	457	457

	2008	
	Carrying Amount	Estimated Fair Value
	(In thousands)	
ASSETS:		
Cash and short-term investments	$ 88,313	$ 88,313
Student loans receivable — net	1,864,607	1,882,676
Accrued interest receivable	40,534	40,534
LIABILITIES:		
Bonds payable	1,924,850	1,882,167
Accrued interest payable	1,423	1,423

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 — The carrying amount is a reasonable estimate of its fair value based on quoted current market prices.

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’s contributions 100% after one year of service. ISM’s contributions to the Plan during fiscal years 2009 and 2008 were approximately $42,000 and $165,000, respectively. Participants of the Plan contributed approximately $70,000 and $237,000 to the Plan during fiscal years 2009 and 2008, 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 years 2009 and 2008 were $14,000 and $69,000, respectively.

9. COMMITMENT

ISM leases office space under the terms of a non-cancellable operating lease. Future minimum required payments under this operating lease at June 30, 2009, were as follows:

Years Ending June 30	Rental Payments
2010	$ 565,000
2011	573,000
2012	582,000
2013	590,000
2014	599,000
Thereafter	913,000
	$ 3,822,000

Rent expense under this operating lease was approximately $472,000 and $594,000 for the fiscal years ended June 30, 2009 and 2008, respectively.

ISM has entered into a sublease agreement for a portion of existing office space. The amount of rental income received for the fiscal year ended June 30, 2009 was $37,000.

10. CONTINGENCIES

ISM is subject to various legal proceedings and claims which arise primarily in the ordinary course of conducting their business. In management’s opinion, the ultimate resolution of such matters will not have a material adverse effect on ISM’s financial position or their results of operations.

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KATZ, SAPPER & MILLER

Katz, Sapper & Miller, LLP
Certified Public Accountants

800 East 96th Street
Suite 500
Indianapolis, IN 46240

Tel 317.580.2000
Fax 317.580.2117

Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

Year Ended June 30, 2009

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

We have audited the financial statements of Indiana Secondary Market for Education Loans, Inc. (ISM), a component unit of the State of Indiana, as of and for the year ended June 30, 2009, and have issued our report thereon, dated October 15, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered ISM's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of ISM's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of ISM's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record process, or report financial data reliably in accordance with generally accepted accounting principles such that there is a more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in the internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether ISM's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain other matters that we reported to management of ISM in a separate letter dated October 15, 2009.

This report is intended solely for the information and use of the Board of Directors, management, the specified lender clients, and the U.S. Department of Education and is not intended to be and should not be used by anyone other than these specified parties.

Katz, Sapp & Miller, LLP

Indianapolis, Indiana
October 15, 2009