Indiana Secondary Market for Education Loans, Inc.

Financial Statements and Supplemental Information for the Years Ended June 30, 2012 and 2011, and Independent Auditors' Report

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

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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, 2012 and 2011, 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, 2012 and 2011, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 16, 2012 presented on pages 25-26, 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 grant agreements and other matters. 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 considered in assessing the results of our audit.

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Accounting principles generally accepted in the United States require that the management's discussion and analysis on pages 3 through 6 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express and opinion or provide any assurance.

Katz, Sapper & Miller, LLP

Indianapolis, Indiana
October 16, 2012

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, as amended.

ISM is currently governed by a nine member Board of Directors who are appointed by the Governor of the State of Indiana. Taxable and tax-exempt bonds are the primary sources of funding for ISM's programs. ISM administers a program for the purchase and servicing of loans guaranteed and reinsured by the United States Department of Education ("US DOED"). ISM's programs are designed to facilitate access for all Indiana residents to educational funding. 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 Governmental 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 changes in financial position for the years ended June 30, 2012 and 2011. The statements of cash flows provide information about the sources and uses of ISM's cash resources for the years ended June 30, 2012 and 2011.

Condensed Financial Information (in thousands)

Financial Position	2012	2011	2010
Cash and investments	$ 176,951	$ 114,432	$ 92,043
Student loans receivable—net	1,363,788	1,502,174	1,619,814
Other assets	42,480	45,565	47,408
Total assets	$ 1,583,219	$ 1,662,171	$ 1,759,265
Taxable bonds payable	$ 1,270,831	$ 1,347,206	$ 1,423,275
Tax-exempt bonds payable	183,000	191,900	225,650
Other liabilities	10,035	10,142	13,520
Total liabilities	1,463,866	1,549,248	1,662,445
Total net assets	119,353	112,923	96,820
Total liabilities and net assets	$ 1,583,219	$ 1,662,171	$ 1,759,265
Operating Results			
Interest on student loans	$ 49,745	$ 53,138	$ 58,912
Special allowance on student loans	(28,204)	(30,167)	(31,707)
Interest income and other	9,186	16,522	14,193
Total operating revenues	30,727	39,493	41,398
Interest expense	17,035	19,407	21,066
Fees and debt issuance costs	1,132	1,170	1,335
Loan servicing and administration	5,871	6,058	6,699
Arbitrage rebate (recovery) provision	259	(3,245)	1,107
Total operating expenses	24,297	23,390	30,207
Change in net assets	$ 6,430	$ 16,103	$ 11,191

Financial Analysis

Financial Position

As of June 30, 2012, total assets decreased $79 million and combined with a decrease in liabilities of $85 million, resulting in an increase to ISM's net assets of $6 million or 6%. This compares to an increase of 17% in 2011. This increase in net assets can be attributed to reduced interest due to less outstanding debt, gains from bond tenders and bond purchases, as well as increased servicing fee revenue.

Cash and investments increased 55% to $177 million as compared to a balance of $114 million in fiscal 2011. The increase in cash is due to existing loan principal payments and the reduced amount of bond tenders from the previous fiscal year and the normal use of cash to pay operating and debt service expenses.

Student loans receivable decreased 9% from $1,502 million in fiscal 2011 to $1,364 million in fiscal 2012, as compared to a 7% decrease from $1,620 million in fiscal 2010 to $1,502 million in fiscal 2011. Effective March 30, 2010, the Health Care and Education Reconciliation Act of 2010 prohibited any new loans after June 2010 under the Federal Family Education Loan Program ("FFELP").

The decrease in student loans receivable was also due to existing loan principal decreases through borrower, consolidation, claims and cancellation payment activity as well as the Special Direct Consolidation Program established by the Department of Education for the period from January 17, 2012 to June 30, 2012. As of June 30, 2012, the student loan portfolio held by ISM was made up of approximately 90% Consolidation Loans and 10% Stafford and PLUS Loans.

Other assets decreased 7% from $45 million in fiscal 2011 to $42 million in fiscal 2012, as compared to a 4% decrease from $47 million in fiscal 2010 to $45 million in fiscal 2011. The majority of this decrease relates to reductions in borrower interest receivable as well as prepaid debt issue costs.

Liabilities decreased 6% from $1,549 million in fiscal 2011 to $1,464 million in fiscal 2012, as compared to a 7% decrease from $1,662 million in fiscal 2010 to $1,549 million in fiscal 2011. The majority of these decreases relate to payments and bond tenders on bonds payable.

Total net assets at June 30, 2012 were $119 million, representing an increase of 6% from $113 million at June 30, 2011. This compared to a 17% increase in fiscal year 2011.

Operating Results

ISM's net assets increased $6 million on operating revenues of $31 million for the fiscal year ended June 30, 2012, compared to an increase in net assets of $16 million from operating revenues of $39 million for the prior fiscal year. The current year change in net assets was primarily due to successful bond tenders and bond purchases resulting in a gain of $7 million, increased servicing fee revenue, 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 also decreased. In addition, interest expense decreased by $2.4 million from the previous year. The market for ISM's student loan auction securities continued to be disrupted for the fiscal year, with auctions initially failing on or around February 14, 2008, and bond interest reverting to the Maximum Auction Rate. This disruption has continued throughout all of fiscal years 2011 and 2012.

Total operating revenues decreased 22%, to $31 million for the fiscal year ended June 30, 2012, from $39 million for the fiscal year ended June 30, 2011. Total operating revenues decreased 5%, to $39 million for the fiscal year ended June 30, 2011, from $41 million for the fiscal year ended June 30, 2010. Interest income on student loans decreased 6% during the fiscal year ended June 30, 2012 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 2012 from a lower general level of interest rates compared to the fixed rate on loans in ISM’s portfolio. The special allowance index changed from three-month commercial paper rate to one-month LIBOR effective April 1, 2012 reducing interest rate basis risk.

Total operating expenses increased 4% from $23 million for the fiscal year ended June 30, 2011, to $24 million for the fiscal year ended June 30, 2012. Total operating expenses decreased 23% from $30 million for the fiscal year ended June 30, 2010, to $23 million for the fiscal year ended June 30, 2011. This current year increase is directly related to the increase in arbitrage liability. In addition there was a slight increase in the cost of tax exempt debt due to a rating change from Standard & Poor’s.

Loan Servicing and ISM’s Loan Purchase Programs

ISM utilizes Affiliated Computer Services, American Education Services, Great Lakes Education Loan Servicing, and Nelnet, Inc. to service its student loan portfolio. Additional contract compliance, loan servicing support and quality control functions are performed in ISM’s Indianapolis location for the existing Federal Family Education Loan Program portfolio. ISM continues to pursue loan purchase opportunities and will seek to acquire loan portfolios.

Recent Developments

ISM received a letter dated February 6, 2009, from the US DOED regarding activities performed by Collegiate Risk Management. This was 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.

As of June 30, 2012, ISM’s portfolio of auction rate securities remain in failed auction mode. ISM continues to seek opportunities to re-finance and tender these securities with excess revenues and recoveries of loan principal. As of June 30, 2012, $471.02 million of securities have been retired as part of ISM’s tender and repurchase programs.

As of August 1, 2010, ISM has subleased a majority of the 33,000 square feet of office space under lease contracts through 2016. As of June 30, 2012, ISM has 5,800 square feet available for sublease.

Effective November 2, 2011, ISM entered into a contract with the Higher Education Loan Authority of the State of Missouri (MOHELA), for the sub-servicing of Direct Student Loans established under the Health Care and Education Reconciliation Act of 2010.

Effective March 14, 2012, Standard & Poor’s lowered the ratings on 195 student loan trusts including ISM. This downgrade was due to the downgrade of United States sovereign debt and the impact to ISM was a change from AAA to AA+. This impacted the applicable percentage for tax exempt debt from 1.75% to 2.50%.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF NET ASSETS
AS OF JUNE 30, 2012 AND 2011
(In thousands)

	2012	2011
ASSETS		
CURRENT ASSETS:		
Cash and equivalents:		
Unrestricted	$ 134,553	$ 91,281
Designated	2,155	1,896
Total cash and equivalents	136,708	93,177
Short-term investments:		
Unrestricted	13,540	6,000
Restricted	8,725	9,235
Student loans receivable — net	73,514	79,962
Accrued interest receivable — student loans receivable	35,605	38,231
Accrued interest receivable — cash and short-term investments	64	2
Prepaids and other assets	1,398	1,316
Total current assets	269,554	227,923
NON-CURRENT ASSETS:		
Investments:		
Certificates of deposit	17,978	6,020
Student loans receivable — net	1,290,274	1,422,212
Prepaids and other assets	5,186	5,673
Capital assets — net	227	343
Total non-current assets	1,313,665	1,434,248
TOTAL	$ 1,583,219	$ 1,662,171
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 7,608	$ 7,994
Accrued interest payable	272	252
Current portion of bonds payable	30,500	
Total current liabilities	38,380	8,246
NON-CURRENT LIABILITIES:		
Bonds payable	1,423,331	1,539,106
Arbitrage rebate payable	2,155	1,896
Total non-current liabilities	1,425,486	1,541,002
Total liabilities	1,463,866	1,549,248
NET ASSETS:		
Invested in capital assets	227	343
Unrestricted	108,246	101,449
Restricted	10,880	11,131
Total net assets	119,353	112,923
TOTAL	$ 1,583,219	$ 1,662,171

See notes to financial statements.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
YEARS ENDED JUNE 30, 2012 AND 2011
(In thousands)

	2012	2011
OPERATING REVENUES:		
Interest on student loans	$ 43,502	$ 45,712
U.S. Secretary of Education:		
Special allowance	(28,204)	(30,167)
Interest subsidy	6,243	7,426
Interest income and other	9,186	16,522
Total operating revenues	30,727	39,493
OPERATING EXPENSES:		
Interest expense	17,035	19,407
Fees and debt issuance costs	1,132	1,170
Loan servicing and administration	5,871	6,058
Arbitrage rebate provision (recovery)	259	(3,245)
Total operating expenses	24,297	23,390
CHANGE IN NET ASSETS	6,430	16,103
NET ASSETS — Beginning of year	112,923	96,820
NET ASSETS — End of year	$ 119,353	$ 112,923

See notes to financial statements.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2012 AND 2011
(In thousands)

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Student loan interest and special allowance payments received	$ 33,554	$ 34,326
Purchase of student loans	(5,068)	(11,362)
Principal receipts on student loans	136,569	119,621
Cash received for other operating activities	115	108
Cash payments for employees and vendors	(7,666)	(7,361)
Net cash provided by operating activities	157,504	135,332
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of certificates of deposit	(11,958)	(3,520)
Net redemption (purchase) of short-term investments	(7,030)	3,221
Net cash used by investing activities	(18,988)	(299)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Repayment and redemption of bonds	(78,240)	(93,119)
Interest paid on bonds	(16,701)	(19,549)
Net cash used by noncapital financing activities	(94,941)	(112,668)
CASH FLOWS FROM CAPITAL ACTIVITIES:		
Proceeds from sale of capital assets, net	1	16
Purchase of capital assets, net	(45)	(291)
Net cash used by capital activities	(44)	(275)
CHANGE IN CASH AND EQUIVALENTS	43,531	22,090
CASH AND EQUIVALENTS — Beginning of year	93,177	71,087
CASH AND EQUIVALENTS — End of year	$ 136,708	$ 93,177

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF CASH FLOWS (CONTINUED)
YEARS ENDED JUNE 30, 2012 AND 2011
(In thousands)

	2012	2011
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Change in net assets	$ 6,430	$ 16,103
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Amortization of loan and bond charges	162	183
Gain on bond tenders	7,035	16,696
Interest expense	17,035	19,407
Provision for allowance for loan losses, net of write-offs and recoveries	(14)	107
Arbitrage rebate provision (recovery)	259	(3,245)
Interest on student loans recapitalized	(31,002)	(31,381)
Change in assets and liabilities:		
Decrease in student loans receivable	148,323	117,533
(Increase) decrease in accrued interest receivable	2,564	(453)
Decrease in prepaids and other assets	7,079	515
Decrease in other liabilities	(367)	(133)
Net cash provided by operating activities	$ 157,504	$ 135,332

See notes to financial statements.

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 an Indiana public benefit 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"). Effective March 30, 2010, the Health Care and Education Reconciliation Act of 2010 prohibited any new loans after June 2010 under FFELP. 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.

ISM's bonds payable mature between 2030 and 2047. ISM's ability to meet its long-term obligations is dependent on borrowing costs, U.S. Department of Education ("US DOED") 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 follows the accounting rules promulgated by the Governmental Accounting Standards Board ("GASB"). Additionally, ISM follows all applicable accounting standards of the Financial Accounting Standards Board ("FASB") issued on or before November 30, 1989, unless pronouncements conflict with or contradict GASB pronouncements.

Student Loans Receivable — Student loans receivable are stated at the principal amounts 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 as well as consolidated rebate fees. 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 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 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. Effective April 1, 2012, the index used to calculate special allowance for loans disbursed after January 1, 2000 is based on one month LIBOR.

Cash and Equivalents — Cash and equivalents may consist of United States Treasury bills, money market funds, certificates of deposit and short-term investments with original maturities of three months or less from the date of acquisition.

Investments — Investments consist of certificates of deposit and guaranteed investment contracts ("GICs"), which are carried at cost and approximate fair value. ISM is restricted to investments that meet the rating requirements per the bond indenture for all funds held within the trust. All cash and investments whose proceeds are designated for the payment of arbitrage rebate liabilities are classified as designated cash and investments (see Note 4).

Interest rate risk is the risk that the value of investments will decrease as a result of a rise in interest rates.

As of June 30, 2012, ISM had the following investments and cash equivalents and maturities:

Investment Type	Fair Value (In thousands)	Maturities (In Years) < 1	1–5	6–10	> 10
Guaranteed investment contracts	$ 8,725	$ 8,725		$	$
Money market funds	108,754	108,754			
Certificates of deposit	31,518	13,540	17,978		
	$ 148,997	$ 131,019	$ 17,978	$	$

As of June 30, 2011, ISM had the following investments and cash equivalents and maturities:

Investment Type	Fair Value (In thousands)	Maturities (In Years) < 1	1–5	6–10	> 10
Guaranteed investment contracts	$ 9,235	$ 9,235	$	$	$
Money market funds	69,149	69,149			
Certificates of deposit	13,296	7,276	6,020		
	$ 91,680	$ 85,660	$ 6,020	$	$

Credit risk is the risk that the value of investments will decrease as a result of a depository financial institution's failure to repay a deposit.

The following table provides information on the credit ratings associated with ISM's investments and cash equivalents as of June 30, 2012:

Investment Type	Fair Value (In thousands)	S & P	Fitch	Moody's
Guaranteed investment contracts	$ 8,725	AA+	unrated	Aa2
Money market funds	108,754	AAAm	unrated	Aaamf
Certificates of deposit	31,518	unrated	unrated	unrated
	$ 148,997			

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 investment balances maintained by ISM exceed federally insured limits. As of June 30, 2012, ISM had cash and short-term investment balances of $19,630,582 with custodial risk. There are no limits on the amount that may be invested in any one financial institution or intermediary. The following shows investments in issuers that represents 5% or more of the total investments at June 30, 2012:

GE Funding Capital Market Services 6%

Wells Fargo Advantage Money Market 73%

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. ISM utilizes two national collection agencies to attempt collection on charged off accounts. The amount attributable to expected recoveries remains in the allowance.

The activity for the allowance for loan losses for the years ended June 30, 2012 and 2011 is as follows:

	2012	2011
	(In thousands)	
Beginning of year	$ 3,067	$ 2,959
Provision for loan losses	100	176
Write-offs of loans	(118)	(76)
Recoveries	4	8
End of year	$ 3,053	$ 3,067

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. 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 issuance costs are amortized using a method that approximates the effective interest method over the terms of their respective agreements, ranging from 30 to 40 years. Unamortized debt issuance costs are included in prepaids and other assets and totaled $5,027,000 and $5,518,000 at June 30, 2012 and 2011, 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 — $108,246,000 and $101,449,000 of ISM's net assets and all related revenues were unrestricted at June 30, 2012 and 2011, respectively. ISM does, however, maintain debt and other arrangements which limit the use of assets. At June 30, 2012 and 2011, ISM's restricted net assets of $8,725,000 and $9,235,000, respectively, per bond reserve requirements (see Note 3) and $2,155,000 and $1,896,000, respectively, reflect amounts restricted to fund the arbitrage rebate payable (see Note 6) and $227,000 and $343,000, respectively, 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, 2012 and 2011, unamortized premiums totaled $22,877,000 and $28,586,000, respectively, and unamortized origination and default fees totaled $6,333,000 and $7,817,000, 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, 2012 and 2011, the unamortized discount totaled $2,169,000 and $2,461,000, respectively.

Servicing Fee — As of June 30, 2012, Affiliated Computer Services, American Education Services, Great Lakes Education Loan Servicing, and Nelnet, Inc. service ISM's student loan portfolio. Servicing fee expense amounts are included in operating expenses in the statement of revenues, 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 investments, sublease rents, servicing fee income, 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 exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. Therefore, no provision or liability for income taxes has been included in the financial statements. In addition, ISM has been determined by the Internal Revenue Service not to be a private foundation within the meaning of Section 509(a) of the Internal Revenue Code. There was no unrelated business income for the years ended June 30, 2012 and 2011.

Use of Estimates — The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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.

Subsequent Events — Management has evaluated the financial statements for subsequent events occurring through October 16, 2012, the date the financial statements were available to be issued.

2. STUDENT LOANS RECEIVABLE — NET

Student loans receivable consist of loans made under the Act and are carried at their unpaid principal balance net of an allowance for loan losses plus unamortized purchase premiums, discounts, origination fees, and default fees. Student loans earn interest at various rates ranging from 1.88% 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 are insured by certain guarantee agencies which are reinsured by the federal government. At June 30, 2012 and 2011, the majority of ISM's student loans were guaranteed by the Pennsylvania Higher Education Assistance Agency (74% as of June 30, 2012 and 2011), California Student Aid Commission/EDFUND (15% as of June 30, 2012 and 2011), or United Student Aid Funds, Inc. (7% as of June 30, 2012 and 2011). Effective in October 2010, California Student Aid Commission/EDFUND was taken over by Educational Credit Management Corp.

Student loans receivable - net as of June 30, 2012 and 2011, consisted of the following:

	2012	2011
	(In thousands)	
Student loans	$ 1,339,798	$ 1,471,298
Purchase premiums, discounts origination fees and other — net	27,043	33,943
Less — allowance for loan losses	(3,053)	(3,067)
	$ 1,363,788	$ 1,502,174
Current portion	$ 73,514	$ 79,962
Long-term portion	$ 1,290,274	$ 1,422,212

3. BONDS PAYABLE

The following table displays the aggregate changes in bonds payable for the years ended June 30, 2012 and 2011:

	2012	2011
	(In thousands)	
Bonds payable — beginning of year	$ 1,539,106	$ 1,648,925
Repayments	(85,275)	(109,819)
Bonds payable — end of year	$ 1,453,831	$ 1,539,106

Bonds payable as of June 30, 2012 and 2011, consisted of the following:

	2012	2011
	(In thousands)	
Auction Rate Certificates	$ 1,453,831	$ 1,539,106

Bonds payable at June 30, 2012, include $1,270.83 million and $183 million of taxable and tax-exempt Auction Rate Certificates ("ARCs"), respectively. The ARCs mature on various dates between December 1, 2018 and May 1, 2047. Interest on the ARCs ranged from 0.00% to 2.745% and 0.00% to 2.841% during the years ended June 30, 2012 and 2011, 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, 2012 (in thousands):

Years Ending June 30	Principal	Interest	Total
2013	$ 30,500	$ 16,737	$ 47,237
2014	30,500	16,668	47,168
2015	30,500	16,600	47,100
2016	30,500	16,531	47,031
2017	30,500	16,462	46,962
2018–2022	30,500	82,037	112,537
2023–2027		81,969	81,969
2028–2032	58,850	80,009	138,859
2033–2037		78,173	78,173
2038–2042	12,050	77,461	89,511
2043–2047	1,199,931	51,440	1,251,371
Total	$ 1,453,831	$ 534,087	$ 1,987,918

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 EQUIVALENTS AND INVESTMENTS

Cash and equivalents and investments as of June 30, 2012 and 2011, consisted of the following:

	2012	2011
	(In thousands)	
Special trust accounts:		
Unrestricted:		
Loan accounts	$ 106,064	$ 62,401
Revenue accounts	2,690	4,852
Designated — rebate accounts	2,155	1,896
	110,909	69,149
Restricted:		
Reserve accounts	8,725	9,235
Operating account	57,317	36,048
	$ 176,951	$ 114,432
Current portion	$ 158,973	$ 108,412
Long term portion	$ 17,978	$ 6,020

5. CAPITAL ASSETS

Capital assets activity for the year ended June 30, 2012 (in thousands) was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Depreciable capital assets:				
Furniture and equipment	$ 652	$ 45	$ 71	$ 626
Leasehold improvements	865			865
Total depreciable capital assets	1,517	45	71	1,491
Less accumulated depreciation	1,174	132	42	1,264
Net depreciable capital assets	$ 343	$ (87)	$ 29	$ 227

Capital assets activity for the year ended June 30, 2011 (in thousands) was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Depreciable capital assets:				
Furniture and equipment	$ 1,468	$ 170	$ 986	$ 652
Leasehold improvements	744	121		865
Total depreciable capital assets	2,212	291	986	1,517
Less accumulated depreciation	1,687	257	770	1,174
Net depreciable capital assets	$ 525	$ 34	$ 216	$ 343

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, 2012 and 2011, the estimated arbitrage rebate liability was $2,155,000 and $1,896,000, 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 years ended June 30, 2012 and 2011:

	2012	2011
	(In thousands)	
Arbitrage rebate payable — beginning of year	$ 1,896	$ 5,141
Provision	259	(3,245)
Ending balance	$ 2,155	$ 1,896

In July 2012, ISM requested a voluntary closing agreement with the Internal Revenue Service (the "IRS") (the process hereinafter referred to as "VCAP"). The request for a closing agreement is based on application of the settlement proposal in IRS Announcement 2012-14 to certain bond issues described in a closing agreement. The bond issues that are covered were issued as tax-exempt qualified student loan bonds described in Section 144 of the Code. The terms of the proposed closing agreement include a payment by ISM as well as other matters required to be addressed by Announcement 2012-14. This proposed agreement would include a payment of arbitrage liability although not due at this time for the bond issues covered.

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 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, 2012 and 2011 were as follows:

	2012	
	Carrying Amount (In thousands)	Estimated Fair Value
ASSETS:		
Cash and equivalents and investments	$ 176,951	$ 176,951
Student loans receivable — net	1,363,788	1,353,196
Accrued interest receivable	35,605	35,605
LIABILITIES:		
Bonds payable	1,453,831	1,323,765
Accrued interest payable	272	272

	2011	
	Carrying Amount (In thousands)	Estimated Fair Value
ASSETS:		
Cash and equivalents and investments	$ 114,432	$ 114,432
Student loans receivable — net	1,502,174	1,486,011
Accrued interest receivable	38,231	38,231
LIABILITIES:		
Bonds payable	1,539,106	1,349,521
Accrued interest payable	252	252

Cash and Equivalents and Investments — Cash and equivalents and 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 estimated fair value is estimated 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. Effective March 16, 2012, this Plan was merged into the EmPower Retirement Savings Plan as part of the contract with Human Capital Concepts, LLC. 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 2012 and 2011 were approximately $30,000 and $28,000, respectively. Participants of the Plan contributed approximately $83,000 and $68,000 to the Plan during fiscal years 2012 and 2011, respectively.

9. COMMITMENT

ISM leases office space under the terms of a long-term non-cancellable operating lease. Future minimum required payments under this operating lease at June 30, 2012, were as follows:

Years Ending June 30	Rental Payments
2013	590,000
2014	599,000
2015	607,000
2016	306,000
	$ 2,102,000

Rent expense under this operating lease was approximately $463,000 and $467,000 for the years ended June 30, 2012 and 2011, respectively.

ISM has entered into sublease agreements for a portion of its office space. The amount of rental income received for the year ended June 30, 2012 was $253,000. The sublease agreements expire in June 2012 and January 2016. At June 30, 2012, the future sublease rental income to be received through January 2016 was as follows:

Years Ending June 30	Rental Income
2013	$ 174,795
2014	177,687
2015	180,579
2016	106,619
	$ 639,680

10. CONTINGENCIES

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

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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, 2012

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, 2012, and have issued our report thereon, dated October 16, 2012. 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

Management of Indiana Secondary Market for Education Loans, Inc. is responsible for establishing and maintaining effective 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 *deficiency in internal control* 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 and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

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

This report is intended solely for the information and use of the Board of Directors and management of ISM, 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, Sapper & Miller, LLP

Indianapolis, Indiana
October 16, 2012