ism
education loans

Indiana Secondary Market for Education Loans, Inc.

Financial Statements and Supplemental Information for the Years Ended June 30, 2013 and 2012, and Independent Auditors' Report

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

TABLE OF CONTENTS

Independent Auditors' Report

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

Report on the Financial Statements

We have audited the accompanying financial statements of Indiana Secondary Market for Education Loans, Inc. ("ISM"), a component unit of the State of Indiana, which comprise the statements of net position as of June 30, 2013 and 2012, and the related statements of revenues, expenses and changes in net position and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on 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 from material misstatement.

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

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the net position of Indiana Secondary Market for Education Loans, Inc. as of June 30, 2013 and 2012, and the changes in its net position and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States.

Report on Required Supplementary Information

Accounting principles generally accepted in the United States require that the management's discussion and analysis on pages 3 through 7 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 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 an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated October 15, 2013, 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering ISM's internal control over financial reporting and compliance.

Katz, Sapp & Miller, LLP

Indianapolis, Indiana
October 15, 2013

MANAGEMENT’S DISCUSSION AND ANALYSIS (UNAUDITED)

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

The financial discussion, analysis, 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's enabling statute was amended effective April 30, 2013 with the signing of SB 532. SB 532 permits ISM to become a direct lender of non-federal, post-secondary education supplemental loans for the purpose of attending both Indiana and non-Indiana colleges and universities. SB 532 also mandates that ISM engage in financial literacy activities.

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. The Health Care and Education Reconciliation Act of 2010 ("HCEARA") eliminated the origination of new FFELP loans after June 30, 2010. This does not impact the terms of existing FFELP loans. ISM continues to administer a program for the servicing of loans guaranteed and reinsured by the United States Department of Education ("US DOED"). In addition, ISM has a teaming arrangement for servicing loans originated under the Federal Direct Student Loan Program working with the Higher Education Loan Authority of the State of Missouri.

With the change to its enabling statue, ISM is focusing on loan programs designed to facilitate access for all Indiana residents to educational funding. In addition, ISM continues to expand its support for 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 position, the statements of revenues, expenses and changes in net position 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 position present the financial position of ISM at the end of the fiscal year and include all assets, liabilities and net position of ISM. The statements of revenues, expenses and changes in net position present ISM's changes in financial position for the years ended June 30, 2013 and 2012. The statements of cash flows provide information about the sources and uses of ISM's cash resources for the years ended June 30, 2013 and 2012.

Condensed Financial Information (in thousands)

Statement of Net Position

As of June 30:	2013	Restated 2012	Restated 2011
Cash and investments	$ 165,027	$ 176,951	$ 114,432
Student loans receivable—net	168,251	1,357,518	1,494,729
Other assets	4,574	37,453	40,061
Total assets	$ 337,852	$ 1,571,922	$ 1,649,222
Taxable bonds payable	$ 189,381	$ 1,270,831	$ 1,347,206
Tax-exempt bonds payable	750	183,000	191,900
Other liabilities	9,558	10,035	10,142
Total liabilities	199,689	1,463,866	1,549,248
Total net position	138,163	108,056	99,974
Total liabilities and net position	$ 337,852	$ 1,571,922	$ 1,649,222

Operating Results

	2013	Restated 2012	Restated 2011
Interest on student loans, including subsidy	$ 43,399	$ 51,230	$ 55,868
Special allowance on student loans	(24,812)	(28,204)	(30,167)
Loss on sale of student loans	(23,796)		
Gain on repurchase of bonds payable	69,717	7,035	16,159
Interest income and other	794	2,151	363
Total operating revenues	65,302	32,212	42,223
Interest expense	17,139	17,035	19,407
Fees	933	965	988
Loan servicing and administration	7,256	5,871	6,058
Distribution to State of Indiana	10,000		
Arbitrage rebate (recovery) provision	(133)	259	(3,245)
Total operating expenses	35,195	24,130	23,208
Change in net position	$ 30,107	$ 8,082	$ 19,015

Financial Analysis

The condensed financial information presented here was restated for the prior fiscal years of 2012 and 2011 due to the adoption of the Governmental Accounting Standards Board ("GASB") Statement No. 65, *Items Previously Reported as Assets and Liabilities*. ISM's management determined it was prudent to choose early adoption of this statement in the circumstances. The impact on the statement of net position was to write off loan origination related fees and debt issuance costs which no longer meet the definition of an asset under GASB 65 and should be expensed in the period incurred. The impact on the statement of revenues, expenses and net position was to increase interest on student loans (due to the elimination of loan origination fee amortization included as a component of interest on student loans) and decrease fees and debt issuance costs.

In June 2013, ISM sold student loans and accrued interest receivable totaling $1,032 million. ISM received total proceeds of approximately $1,021 million resulting in a loss on the sale of $24 million. ISM used the proceeds from the sale to repurchase outstanding bonds payable of $1,244 million at a discount resulting in a gain of $70 million.

Statement of Net Position

As of June 30, 2013, total assets decreased $1,234 million and combined with a decrease in liabilities of $1,264 million, resulted in an increase to ISM's net position of $30 million or 28%. This increase was the result of a sale of student loans reducing student loans receivable with the resulting proceeds used to extinguish outstanding debt. This compares to an increase of 8% in 2012.

Cash and investments decreased 7% to $165 million as compared to a balance of $177 million in fiscal 2012. The decrease in cash is the result of a successful bond tender that occurred in the month of June, as well as the normal use of cash to pay operating and debt service expenses.

Student loans receivable decreased 88% from $1,358 million in fiscal 2012 to $168 million in fiscal 2013, as compared to a 9% decrease from $1,495 million in fiscal 2011 to $1,358 million in fiscal 2012. Effective March 30, 2010, the Health Care and Education Reconciliation Act of 2010 prohibited origination of any new loans after June 2010 under the Federal Family Education Loan Program ("FFELP"). ISM sold a large portfolio of student loans in June 2013.

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 impact of the Special Direct Consolidation Program established by the Department of Education. As of June 30, 2013, the student loan portfolio held by ISM was made up of approximately 86% Consolidation Loans and 14% Stafford and PLUS Loans.

Other assets decreased 88% from $37 million in fiscal 2012 to $4.5 million in fiscal 2013, as compared to a 7% decrease from $40 million in fiscal 2011 to $37 million in fiscal 2012. The majority of this decrease relates to reductions in borrower interest receivable and changes in servicing cash receivable.

Liabilities decreased 86% from $1,464 million in fiscal 2012 to $200 million in fiscal 2013, as compared to a 6% decrease from $1,549 million in fiscal 2011 to $1,464 million in fiscal 2012. The bulk of this decrease relates to the successful bond tender noted above.

Total net position at June 30, 2013 was $138 million, representing an increase of 28% from $108 million at June 30, 2012. This compared to an 8% increase in fiscal year 2012.

Operating Results

ISM's net position increased $30 million on operating revenues of $65 million for the fiscal year ended June 30, 2013, compared to an increase in net position of $8 million from operating revenues of $32 million for the prior fiscal year. The current year change in net position was primarily due to below par bond repurchases resulting in a gain of $70 million. Interest rates increased slightly over the past year and as a result interest expense increased by $104 thousand 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 2012 and 2013.

In June 2013, ISM sold a significant portion of its outstanding student loan portfolio and used the proceeds to repurchase outstanding bonds payable. ISM recorded a loss on the sale of student loans of $24 million and a gain on the repurchase of the bonds payable of $70 million.

Total operating revenues increased 103%, to $65 million for the fiscal year ended June 30, 2013, from $32 million for the fiscal year ended June 30, 2012. Total operating revenues decreased 24%, to $32 million for the fiscal year ended June 30, 2012, from $42 million for the fiscal year ended June 30, 2011. Interest income on student loans decreased 16% during the fiscal year ended June 30, 2013 due to the reduction in the size of the portfolio. The special allowance on student loans decreased during fiscal year 2013 due to reduced loan balances. 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 46% from $24 million for the fiscal year ended June 30, 2012, to $35 million for the fiscal year ended June 30, 2013. 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. This current year increase is directly attributable to the distribution to the State of Indiana. In addition there was a slight increase in the cost of debt due to a slightly higher cost of funds.

Loan Servicing and ISM's Loan Programs

ISM utilizes American Education Services, Xerox Education Services, LLC, and Great Lakes Education Loan Servicing 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 has a contract with Aspire Resources, Inc. and First Merchants Bank, an Indiana chartered bank, to originate loans under the Hoosier Education Loan Partnership ("HELP").

Recent Developments

As of June 30, 2013, 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, 2013, $1,742 million of securities have been retired as part of ISM's tender and repurchase programs. As of July 25, 2013, ISM had no remaining tax-exempt or subordinate debt.

Requests of Information

This financial report is designed to provide a general overview of ISM's finances for all those with an interest in ISM's finances. Questions concerning any of the information should be addressed to Indiana Secondary Market for Education Loans, Inc., 251 North Illinois Street, Suite 400, Indianapolis, Indiana 46204.

BASIC FINANCIAL STATEMENTS

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF NET POSITION
AS OF JUNE 30, 2013 AND 2012
(In thousands)

	2013	Restated 2012
ASSETS		
CURRENT ASSETS:		
Cash and equivalents:		
Unrestricted	$ 121,772	$ 134,553
Designated	2,022	2,155
Total cash and equivalents	123,794	136,708
Short-term investments:		
Unrestricted	24,091	13,540
Restricted	2,000	8,725
Student loans receivable — net	14,115	72,029
Accrued interest receivable — student loans receivable	4,307	35,605
Accrued interest receivable — cash and short-term investments	40	64
Prepaids and other assets	65	1,557
Total current assets	168,412	268,228
NON-CURRENT ASSETS:		
Investments:		
Certificates of deposit	15,143	17,978
Student loans receivable — net	154,136	1,285,489
Capital assets — net	161	227
Total non-current assets	169,440	1,303,694
TOTAL	$ 337,852	$ 1,571,922
LIABILITIES AND NET POSITION		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 7,486	$ 7,608
Accrued interest payable	50	272
Current portion of bonds payable	750	30,500
Total current liabilities	8,286	38,380
NON-CURRENT LIABILITIES:		
Bonds payable	189,381	1,423,331
Arbitrage rebate payable	2,022	2,155
Total non-current liabilities	191,403	1,425,486
Total liabilities	199,689	1,463,866
NET POSITION:		
Invested in capital assets	161	227
Unrestricted	133,980	96,949
Restricted	4,022	10,880
Total net position	138,163	108,056
TOTAL	$ 337,852	$ 1,571,922

See notes to financial statements.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION
YEARS ENDED JUNE 30, 2013 AND 2012
(In thousands)

	2013	Restated 2012
OPERATING REVENUES:		
Interest on student loans	$ 38,279	$ 44,987
U.S. Secretary of Education:		
Special allowance	(24,812)	(28,204)
Interest subsidy	5,120	6,243
Loss on sales of student loans and accrued interest	(23,796)	
Gain on repurchase of bonds payable	69,717	7,035
Interest income and other	794	2,151
Total operating revenues	65,302	32,212
OPERATING EXPENSES:		
Interest expense	17,139	17,035
Fees	933	965
Loan servicing and administration	7,256	5,871
Distribution to State of Indiana	10,000	
Arbitrage rebate provision (recovery)	(133)	259
Total operating expenses	35,195	24,130
CHANGE IN NET POSITION	30,107	8,082
NET POSITION — Beginning of year	108,056	99,974
NET POSITION — End of year	$ 138,163	$ 108,056

See notes to financial statements.

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2013 AND 2012
(In thousands)

	2013	Restated 2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Student loan interest and special allowance payments received	$ 27,163	$ 33,554
Proceeds from sales of student loans and accrued interest	1,051,459	
Purchase of student loans		(5,068)
Principal receipts on student loans	136,621	136,569
Distribution to State of Indiana	(10,000)	
Cash received for other operating activities	819	115
Cash payments for employees and vendors	(6,624)	(7,666)
Net cash provided by operating activities	1,199,438	157,504
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net maturity (purchase) of certificates of deposit	2,835	(11,958)
Net (purchase) of short-term investments	(3,826)	(7,030)
Net cash used by investing activities	(991)	(18,988)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Repayment and redemption of bonds	(1,193,984)	(78,240)
Interest paid on bonds	(17,360)	(16,701)
Net cash used by noncapital financing activities	(1,211,344)	(94,941)
CASH FLOWS FROM CAPITAL ACTIVITIES:		
Proceeds from sale of capital assets, net		1
Purchase of capital assets, net	(17)	(45)
Net cash used by capital activities	(17)	(44)
CHANGE IN CASH AND EQUIVALENTS	(12,914)	43,531
CASH AND EQUIVALENTS — Beginning of year	136,708	93,177
CASH AND EQUIVALENTS — End of year	$ 123,794	$ 136,708

INDIANA SECONDARY MARKET FOR EDUCATION LOANS, INC.

STATEMENTS OF CASH FLOWS (CONTINUED)
YEARS ENDED JUNE 30, 2013 AND 2012
(In thousands)

	2013	Restated 2012
RECONCILIATION OF CHANGE IN NET POSITION TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Change in net position	$ 30,107	$ 8,082
Adjustments to reconcile change in net position to net cash provided by operating activities:		
Depreciation expense	82	132
Loss on sales of student loans and accrued interest	23,796	
Gain on bond repurchase	(69,717)	(7,035)
Interest expense	17,139	17,035
Provision for allowance for loan losses, net of write-offs and recoveries	112	(14)
Arbitrage rebate provision (recovery)	(133)	259
Interest on student loans recapitalized	(594)	(31,002)
Change in assets and liabilities:		
Decrease in student loans receivable	1,165,583	163,877
(Increase) decrease in accrued interest receivable	31,916	2,564
Decrease in prepaids and other assets	1,491	3,973
Decrease in other liabilities	(344)	(367)
Net cash provided by operating activities	$ 1,199,438	$ 157,504

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") 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 origination of 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 discretely presented proprietary component unit of the State of Indiana.

ISM's bonds payable mature between 2014 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. The Governmental Accounting Standards Board ("GASB") is the accepted standard-setting body for establishing governmental and financial reporting principles. ISM follows GASB pronouncements as codified under GASB Statement No. 62.

ISM elected to early adopt GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. The application of GASB Statement No. 65 required that the 2012 financial statements be restated to write off loan origination and debt issuance costs. The restatement resulted in the following changes to the fiscal 2012 financial statements (in thousands):

Loan origination fees (included in student loans receivable)	$ (6,270)
Prepaid expenses and other assets	(5,027)
Net position – unrestricted	(4,500)
Net position – restricted	(251)
Total net position – end of year	(11,297)
Total net position – beginning of year	(12,949)
Interest on student loans	1,485
Fees and debt issuance costs	(167)
Change in net position	1,652

Student Loans Receivable — Student loans receivable are stated at the principal amounts outstanding adjusted for an estimated allowance for loan losses, and unamortized purchase premiums or discounts. The related interest income generated from student loans is offset by premium amortization. ISM amortizes loan premiums and loan discounts over the estimated average life of the loan on a straight-line basis over 10 years, which approximates the effective interest method.

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 ISM. 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 which approximates 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, 2013, 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	$ 8,607	$ 8,607	$	$	$
Money market funds	106,067	106,067			
Certificates of deposit	32,626	17,783	14,843		
	$ 147,300	$ 132,457	$ 14,843	$	$

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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	$	$

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, 2013:

Investment Type	Fair Value (In thousands)	S & P	Fitch	Moody's
Guaranteed investment contracts	$ 8,607	AA+	unrated	A1
Money market funds	106,067	AAAm	unrated	Aaa-mf
Certificates of deposit	32,626	unrated	unrated	unrated
	$ 147,300			

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, 2013, ISM had cash and short-term investment balances of $17,477,203 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, 2013:

GE Funding Capital Market Services	6%
Northern Institutional U.S. Gov't Select Money Market	72%

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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, 2013 and 2012 is as follows:

	2013	2012
	(In thousands)	
Beginning of year	$ 3,053	$ 3,067
Provision for loan losses	298	100
Write-offs of loans	(187)	(118)
Recoveries	1	4
End of year	$ 3,165	$ 3,053

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, document deficiencies, 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.

Capital Assets — Capital assets consist of office furniture, equipment and leasehold improvements recorded at cost. Depreciation is charged to operations using 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 Position — $133,980,000 and $96,949,000 of ISM's net position and all related revenues were unrestricted at June 30, 2013 and 2012, respectively. ISM does, however, maintain debt and other arrangements which limit the use of assets. At June 30, 2013 and 2012, ISM's restricted net position of $2,000,000 and $8,725,000, respectively, per bond reserve requirements (see Note 3) and $2,022,000 and $2,155,000, respectively, reflect amounts restricted to fund the arbitrage rebate payable (see Note 6) and $161,000 and $227,000, respectively, reflect amounts invested in capital assets (see Note 5).

1. DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 are amortized using a method which approximates the effective interest method over the estimated life of the loans (10 years). At June 30, 2013 and 2012, unamortized premiums totaled $2,642,000 and $22,942,000, respectively.

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, 2013 and 2012, the unamortized discount totaled $281,000 and $2,169,000, respectively.

Servicing Fees — As of June 30, 2013, Affiliated Computer Services, American Education Services, and Great Lakes Education Loan Servicing 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 position.

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, the U.S. Secretary of Education, and gains (losses) from the sale of student loans and early redemption of bonds payable. 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, 2013 and 2012.

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 15, 2013, 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 and discounts. Student loans earn interest at various rates ranging from 1.75% 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, 2013 and 2012, the majority of ISM's student loans were guaranteed by the Pennsylvania Higher Education Assistance Agency (63% as of June 30, 2013), California Student Aid Commission/EDFUND (20% as of June 30, 2013), and Great Lakes Higher Education Corporation (8% as of June 30, 2013). Effective in October 2010, California Student Aid Commission/EDFUND was taken over by Educational Credit Management Corp.

In November 2012, ISM sold student loans receivable with a principal balance of approximately $30,163,000 and related accrued interest receivable balance of approximately $344,000. ISM sold the loans at a premium resulting in total proceeds of approximately $30,838,000. ISM recorded a gain on the sale of the student loans $332,000.

In June 2013, ISM sold student loans receivable with a principal balance of approximately $1,004,616,000 and related accrued interest receivable of approximately $27,200,000. ISM sold the student loans receivable at a discount resulting in total proceeds of approximately $1,020,621,000. ISM recorded a loss on the sale of the student loans of $24,129,000. Premiums and discounts associated with the loans that were sold totaling approximately $12,931,000 were written off and included in the loss on the sale of the loans. The sale agreement includes certain recourse provisions where ISM is required to repurchase loans that have inaccuracies that materially and adversely affect the value of the loan. The recourse provision is in effect through the life of the student loans. ISM has 60 days to cure any identified issue prior to being required to repurchase the loan. ISM has recorded an estimated recourse liability which is included as a component of the allowance for loan losses.

Student loans receivable - net as of June 30, 2013 and 2012, consisted of the following:

	2013	Restated 2012
	(In thousands)	
Student loans	$ 169,055	$ 1,339,798
Purchase premiums and discounts — net	2,361	20,773
Less — allowance for loan losses	(3,165)	(3,053)
	$ 168,251	$ 1,357,518
Current portion	$ 14,115	$ 72,029

3. BONDS PAYABLE

The following table displays the aggregate changes in bonds payable for the years ended June 30, 2013 and 2012:

	2013	2012
	(In thousands)	
Bonds payable — beginning of year	$ 1,453,831	$ 1,539,106
Repayments	(1,263,700)	(85,275)
Bonds payable — end of year	$ 190,131	$ 1,453,831

Bonds payable as of June 30, 2013 and 2012, consisted of the following:

	2013	2012
	(In thousands)	
Auction Rate Certificates	$ 190,131	$ 1,453,831

Bonds payable at June 30, 2013, include $189.381 million and $750,000 of taxable and tax-exempt Auction Rate Certificates ("ARCs"), respectively. The ARCs mature on various dates between December 1, 2014 and May 1, 2047. Interest on the ARCs ranged from 0.00% to 2.749% and 0.00% to 2.745% during the years ended June 30, 2013 and 2012, 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.

In November 2012, ISM repurchased $17,800,000 of outstanding bonds payable resulting in a gain of approximately $1,189,000. In April 2013, ISM repurchased $1,500,000 of outstanding bonds payable resulting in a gain of approximately $85,000. In June 2013, ISM repurchased $1,244,400,000 of outstanding bonds payable with the proceeds from the sale of student loans discussed in Note 2. The bond repurchase resulted in a gain of approximately $68,443,000.

3. BONDS PAYABLE (CONTINUED)

The following table displays scheduled debt maturities and contractual interest payments for bonds payable at June 30, 2013 (in thousands):

Years Ending June 30	Principal	Interest	Total
2014	$ 750	$ 2,387	$ 3,137
2015		2,386	2,386
2016		2,386	2,386
2017		2,386	2,386
2018		2,386	2,386
2019–2023		11,931	11,931
2024–2028		11,931	11,931
2029–2033		11,931	11,931
2034–2038	12,000	11,843	23,843
2039–2043		11,175	11,175
2044–2047	177,381	4,588	181,969
Total	$ 190,131	$ 75,330	$ 265,461

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, 2013 and 2012, consisted of the following:

	2013	2012
	(In thousands)	
Special trust accounts:		
Unrestricted:		
Loan accounts	$ 105,578	$ 106,064
Revenue accounts	489	2,690
Designated — rebate accounts	2,022	2,155
	108,089	110,909
Restricted:		
Reserve accounts	2,000	8,725
Operating account	54,939	57,317
	$ 165,028	$ 176,951
Current portion	$ 149,885	$ 158,973
Long-term portion	$ 15,143	$ 17,978

5. CAPITAL ASSETS

Capital assets activity for the year ended June 30, 2013 (in thousands) was as follows:

	Beginning Balance	Additions	Retirements	Ending Balance
Depreciable capital assets:				
Furniture and equipment	$ 626	$ 17	$ 50	$ 593
Leasehold improvements	865			865
Total depreciable capital assets	1,491	17	50	1,458
Less accumulated depreciation	1,264	82	49	1,297
Net depreciable capital assets	$ 227	$ (65)	$ 1	$ 161

5. CAPITAL ASSETS (CONTINUED)

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

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, 2013 and 2012, the estimated arbitrage rebate liability was $2,022,000 and $2,155,000, 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, 2013 and 2012:

Arbitrage rebate payable — beginning of year	$ 2,155	$ 1,896
Provision	(133)	259
End of Year	$ 2,022	$ 2,155

6. ARBITRAGE REBATE PAYABLE (CONTINUED)

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. Effective September 10, 2013, ISM has entered into a voluntary closing agreement with the IRS. The bonds are no longer outstanding as of July 25, 2013.

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 valuation 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, 2013 were as follows:

	2013	
	Carrying Amount	Estimated Fair Value
	(In thousands)	
ASSETS:		
Cash and equivalents and investments	$ 165,028	$ 165,028
Student loans receivable — net	168,251	164,015
Accrued interest receivable	4,307	4,307
LIABILITIES:		
Bonds payable	190,131	179,674
Accrued interest payable	50	50

7. FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

The estimated fair values of ISM's financial instruments as of June 30, 2012 were as follows:

	Restated 2012	
	Carrying Amount	Estimated Fair Value
	(In thousands)	
ASSETS:		
Cash and equivalents and investments	$ 176,951	$ 176,951
Student loans receivable — net	1,357,518	1,353,196
Accrued interest receivable	35,605	35,605
LIABILITIES:		
Bonds payable	1,453,831	1,323,765
Accrued interest payable	272	272

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 Code. All employees 18 or older are eligible to participate on the first day of the month following their hire date. ISM makes a safe harbor matching contribution equal to 100% of the first 4% that each participant contributes to the Plan. ISM also may make a discretionary profit sharing contribution to Plan for participants who are employed at the end of the Plan year. Participants are 100% vested in ISM's contributions after one year of service. ISM's contributions to the Plan during fiscal years 2013 and 2012 were approximately $32,000 and $30,000, 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, 2013, were as follows:

Years Ending June 30	Rental Payments
2014	$ 599,000
2015	607,000
2016	306,000
	$ 1,512,000

Rent expense under this operating lease was approximately $476,000 and $463,000 for the years ended June 30, 2013 and 2012, respectively.

ISM has entered into sublease agreements for a portion of its office space. The amount of rental income received for the years ended June 30, 2013 and 2012 was approximately $175,000 and $253,000, respectively. The sublease agreements expire in January 2016. At June 30, 2013, the future sublease rental income to be received through January 2016 was as follows:

Years Ending June 30	Rental Income
2014	$ 177,690
2015	180,583
2016	106,606
	$ 464,879

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.

.

* * * * * *

OTHER REPORT

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

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

We have audited, in accordance with the 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, the financial statements of Indiana Secondary Market for Education Loans, Inc. ("ISM"), a component unit of the State of Indiana, which comprise the statement of net position as of June 30, 2013, and the related statements of revenues, expenses and changes in net position and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated October 15, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered ISM's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness ISM's internal control.

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 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. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

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 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*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this report is not suitable for any other purpose.

Katz, Sapper & Miller, LLP

Indianapolis, Indiana
October 15, 2013