



UNIVERSITY OF SOUTH ALABAMA

Basic Financial Statements and Supplementary Information
on Federal Awards Programs

Year ended September 30, 2005

UNIVERSITY OF SOUTH ALABAMA

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UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

Introduction

The following discussion presents an overview of the financial position and financial activities of the University of South Alabama (the University), including the University of South Alabama Hospitals (the Hospitals), a division of the University, at September 30, 2005 and 2004 and for the years then ended. This discussion was prepared by University management and should be read in conjunction with the financial statements and notes thereto, which follow.

The basic financial statements of the University consist of the University and its component units. The financial position and results of operations of the component units are either blended with the University's financial position and results of operations or are discretely presented. The treatment of each component unit is governed by pronouncements issued by the Governmental Accounting Standards Board. As more fully described in footnote number one to the basic financial statements, the University of South Alabama Professional Liability Trust Fund and the University of South Alabama General Liability Trust Fund are reported as blended component units. The University of South Alabama Foundation and the University of South Alabama Health Services Foundation are discretely presented.

Financial Highlights

At September 30, 2005, 2004 and 2003, the University has total assets of \$485,986,000, \$460,180,000, and \$391,929,000, respectively; total liabilities of \$230,030,000, \$226,070,000 and \$173,737,000, respectively; and net assets of \$255,956,000, \$234,110,000 and \$218,192,000, respectively. University net assets increased \$21,846,000 during the year ended September 30, 2005 compared to increases of \$15,918,000 and \$8,871,000 in the years ended September 30, 2004 and 2003, respectively.

An overview of each statement is presented herein along with a financial analysis of the transactions impacting each statement. Where appropriate, comparative financial information is presented to assist in the understanding of this analysis.

Analysis of Financial Position and Results of Operations

Statement of Net Assets

The statement of net assets presents the assets, liabilities, and net assets of the University at September 30, 2005 and 2004. The net assets are displayed in three parts: invested in capital assets, net of related debt, restricted and unrestricted. Restricted net assets may either be expendable or nonexpendable and are those assets that are restricted by law or external donor. Unrestricted net assets, while they are generally designated for specific purposes, are available for use by the University to meet current expenses for any purpose. The statement of net assets, along with all of the University's basic financial statements, are prepared under the economic resources measurement focus and the accrual basis of accounting, whereby revenues are recognized when earned and expenses are recognized when incurred by the University, regardless of when cash is exchanged.

Assets included in the statement of net assets are classified as current or noncurrent. Current assets consist primarily of cash and cash equivalents, investments, and hospital patient accounts receivable. Of these amounts, cash and cash equivalents, investments, and patient accounts receivable comprise approximately 20%, 44%, and 19%, respectively, of current assets at September 30, 2005. Noncurrent assets at September 30, 2005 consist primarily of capital assets.

UNIVERSITY OF SOUTH ALABAMA
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Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

The Condensed Schedule of Net Assets at September 30, 2005, 2004 and 2003 follows (in thousands):

Condensed Schedule of Net Assets			
	2005	2004	2003
Assets:			
Current	\$ 170,419	161,931	112,990
Capital assets	231,027	216,767	224,433
Other noncurrent	84,540	81,482	54,506
Total assets	485,986	460,180	391,929
Liabilities:			
Current	72,834	66,381	71,158
Noncurrent	157,196	159,689	102,579
Total liabilities	230,030	226,070	173,737
Net assets:			
Invested in capital assets, net of related debt	127,805	116,037	120,583
Restricted, nonexpendable	12,208	10,372	10,029
Restricted, expendable	9,997	7,150	25,722
Unrestricted	105,946	100,551	61,858
Total net assets	\$ 255,956	234,110	218,192

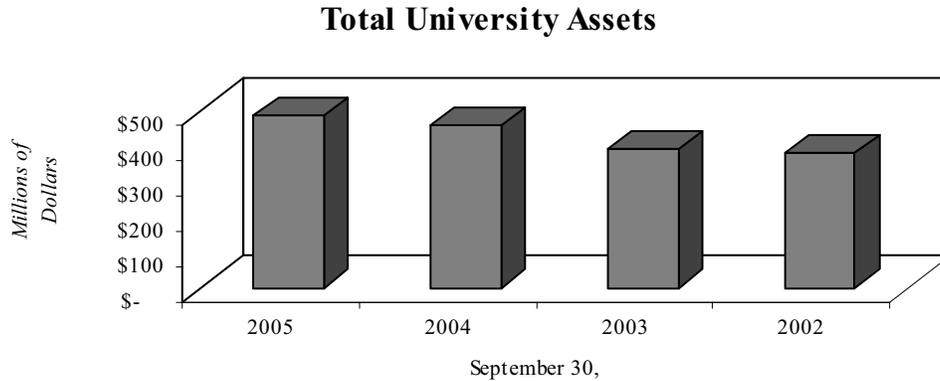
University cash, cash equivalents, and investments (current and noncurrent) remained relatively constant between September 30 2005 and 2004, increasing by \$5,181,000 to \$184,155,000. This follows a significant increase between 2003 and 2004, which resulted from cash generated by the issuance of the University's Series 2004 Tuition Revenue Refunding and Capital Improvement Bonds and from proceeds from the sale of two buildings, one to the USA Research and Technology Corporation and one to an unrelated party. In a related fluctuation, deposits with trustees decreased from \$10,331,000 at September 30, 2003 to \$51,000 at September 30, 2004 due to the release of funds on deposit related to the repayment of Series 1993 bonds. Patient accounts receivable increased from \$28,744,000 to \$32,201,000 between 2004 and 2005, reflecting an overall increase in hospital activity, specifically activity at the end of 2005. Other accounts receivable increased from \$10,105,000 to \$13,749,000 between 2004 and 2005 due primarily to the addition of patient care receivables related to the USA Cancer Research Institute.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

Total assets of the University as of September 30 are as follows:



Current liabilities consist primarily of accounts payable and accrued liabilities and decreased from \$71,158,000 to \$66,381,000 between September 30, 2003 and 2004, while increasing to \$72,834,000 at September 30, 2005. The fluctuations primarily resulted from changes in the accrual for the University's payroll and related expenses in the three years. Noncurrent liabilities consist primarily of bonded indebtedness and notes payable. Long-term debt decreased from \$131,809,000 to \$127,133,000 between September 30, 2004 and 2005 primarily as a result of a repayment of principal on notes and bonds payable. Long-term debt increased from \$104,809,000 to \$131,809,000 between September 30, 2003 and 2004 primarily due to the issuance of the University's Series 2004 Tuition Revenue Refunding and Capital Improvement Bonds along with increases in liabilities related to the University Professional Liability Trust Fund.

Net assets represent the residual interest in the University's assets after liabilities are deducted. Net assets are classified into one of four categories:

Net assets invested in capital assets, net of related debt, represent the University's capital assets less accumulated depreciation and outstanding principal balances of the debt attributable to the acquisition, construction, or improvement of those assets.

Restricted nonexpendable net assets consist primarily of the University's permanent endowment funds. While earnings from these funds may be expended, the corpus may not be expended for any reason and must remain intact with the University in perpetuity.

Restricted expendable net assets are subject to externally imposed restrictions governing their use. The funds are restricted primarily for debt service, capital projects, student loans, and scholarship purposes.

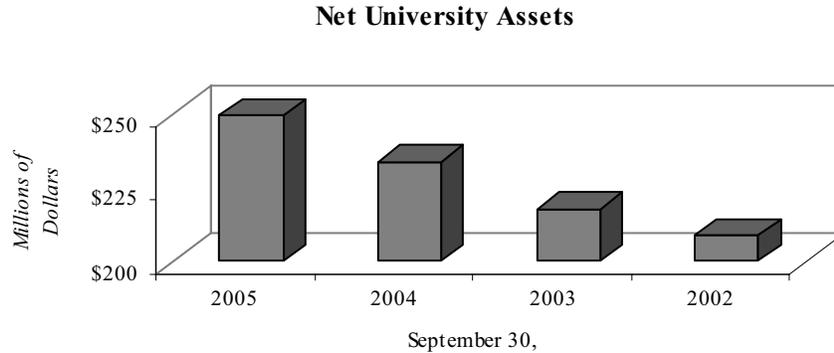
Unrestricted net assets represent those net assets not subject to externally imposed stipulations. Even though these funds are not legally restricted, the majority of the University's unrestricted net assets have been internally designated for various projects, all supporting the missions of the University. These unrestricted net assets include funds for various academic and research programs, auxiliary operations (including the bookstore, student housing and dining services), student programs, capital projects and general operations.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

Net assets of the University for the last four years are as follows:



Net assets invested in capital assets, net of related debt, increased approximately \$11,768,000 from September 30, 2004 to 2005. This increase was due primarily to increase in construction activity and the repayment of principal on notes and bonds payable. Restricted expendable net assets decreased from \$25,722,000 at September 30, 2003 to \$7,150,000 at September 30, 2004 primarily due to the release of restrictions on certain funds related to the refunding of the Series 1993 bonds. Other net assets balances were relatively constant among the 2003 to 2005 fiscal years.

Statement of Revenues, Expenses, and Changes in Net Assets

Changes in total University net assets as reported in the statement of net assets are based on the activity presented in the statement of revenues, expenses, and changes in net assets. The purpose of this statement is to present the change in net assets resulting from revenues earned by the University, both operating and nonoperating, and the expenses incurred by the University, both operating and nonoperating, as well as any other revenues, expenses, gains, and losses earned or incurred by the University.

Generally, operating revenues have the characteristics of exchange transactions and are received or accrued for providing goods and services to the various customers and constituencies of the University. These include hospital patient care services, tuition and fees (net of scholarship discounts and allowances), most non-capital grants and contracts and revenues from auxiliary activities and sales and services of education activities (primarily athletic activities.) Operating expenses are those expenses paid or accrued to acquire or produce the goods and services provided in return for the operating revenues, and to carry out the mission of the University.

Nonoperating revenues have the characteristics of nonexchange transactions and are revenues generally earned for which goods and services are not provided, such as investment income, capital appropriations, gifts and other contributions. State appropriations are required by the Governmental Accounting Standards Board to be classified as nonoperating revenues. Nonoperating expenses are those expenses required in the operation and administration of the University, but not directly incurred to acquire or produce the goods and services provided in the return for operating revenues. Such nonoperating expenses include interest on the University's indebtedness and losses related to the disposition of capital assets.

UNIVERSITY OF SOUTH ALABAMA
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Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

The Condensed Schedule of Revenues, Expenses, and Changes in Net Assets for the years ended September 30, 2005, 2004 and 2003 follows (in thousands):

Condensed Schedule of Revenues, Expenses, and Changes in Net Assets			
	2005	2004	2003
Operating revenues:			
Tuition and fees	\$ 43,737	38,832	32,592
Net patient service revenue	219,006	211,124	208,698
Federal, state and private grants and contracts	73,385	72,228	64,201
Other	28,322	25,067	23,684
	364,450	347,251	329,175
Operating expenses:			
Salaries and benefits	307,039	292,089	276,808
Supplies and other services	105,116	106,564	103,714
Other	32,432	31,913	30,465
	444,587	430,566	410,987
Operating loss	(80,137)	(83,315)	(81,812)
Nonoperating revenues (expenses):			
State appropriations	86,622	84,233	83,846
Other, net	5,664	1,807	(828)
Net nonoperating revenues	92,286	86,040	83,018
Income before capital contributions and additions to endowment	12,149	2,725	1,206
Capital contributions and additions to endowment	9,697	13,193	7,665
Increase in net assets	21,846	15,918	8,871
Beginning net assets	234,110	218,192	209,321
Ending net assets	\$ 255,956	234,110	218,192

In 2005, 2004 and 2003, approximately 60%, 61% and 63%, respectively, of operating revenues of the University were net patient service revenue. Excluding net patient service revenue, state appropriations represent the largest component of total university revenues, approximately 18% of total revenues in fiscal 2005. Also in 2005 tuition and fees charged to students and grants and contracts (federal, state and private) represented approximately 9% and 16% of total revenues, respectively.

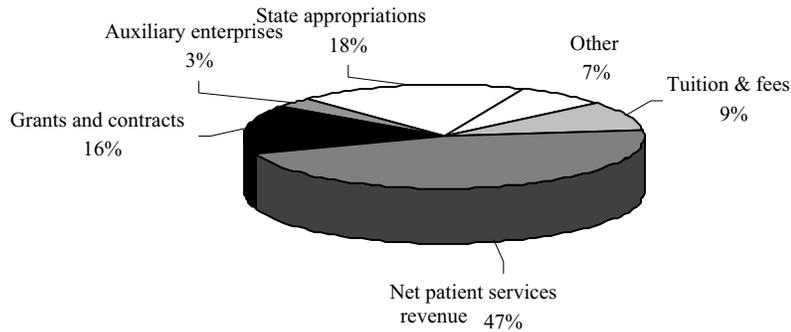
UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

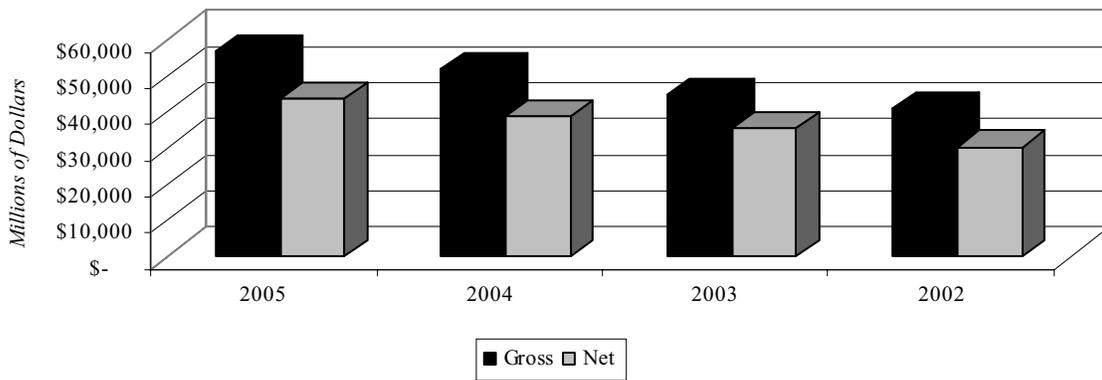
A summary of University revenues for the year ended September 30, 2005 is presented below:

Total Revenues



Tuition and fees have increased significantly in each of the last three years. These increases are due to increases in tuition and fee rates charged to students as well as to an increase in the number of student enrolled. Additionally, tuition and fees as a percent of total operating revenue (excluding state appropriations) continue to increase, from 9.5% of operating revenues in 2002 to 12.0% in 2005. Tuition and fees, gross and net of scholarship allowances, for the past four fiscal years are as follows:

Tuition and Fees



UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

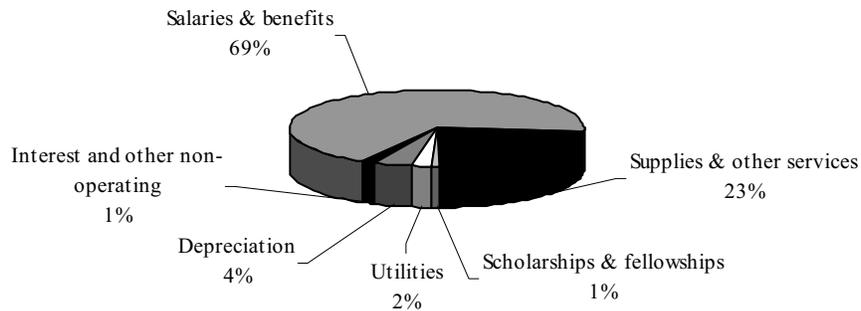
Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

In addition to tuition and fees, other operating revenues increased from approximately \$10,495,000 in 2004 to \$13,431,000 in 2005 primarily due to increases in patient care revenue from the USA Cancer Research Institute. Financial market conditions have resulted in a consistent increase in investment income from \$1,650,000 in 2003 to \$3,789,000 in 2004 and \$7,545,000 in 2005.

University expenses are presented using their natural expense classifications. A summary of University expenses for the year ended September 30, 2005 is presented below

Total Expenses



While the University reports its expenses on a natural expense classification basis, functional classifications represent expenses categorized based on the function within the University. Such University functions include instruction, research, public service, academic support, student services, institutional support, scholarships, and operation and maintenance of plant. Expenses related to auxiliary enterprise activities and the hospitals are presented separately.

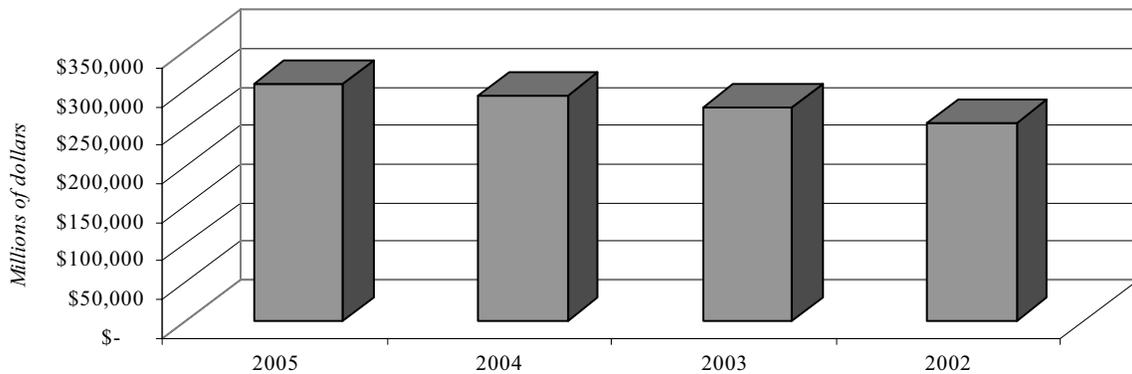
UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

In 2005, 2004 and 2003, approximately 69%, 68% and 67%, respectively, of the University's total operating expenses were salaries and benefits. Salaries and benefits have steadily increased over the last four years, resulting primarily from increases in salary rates to faculty and staff, as shown below:

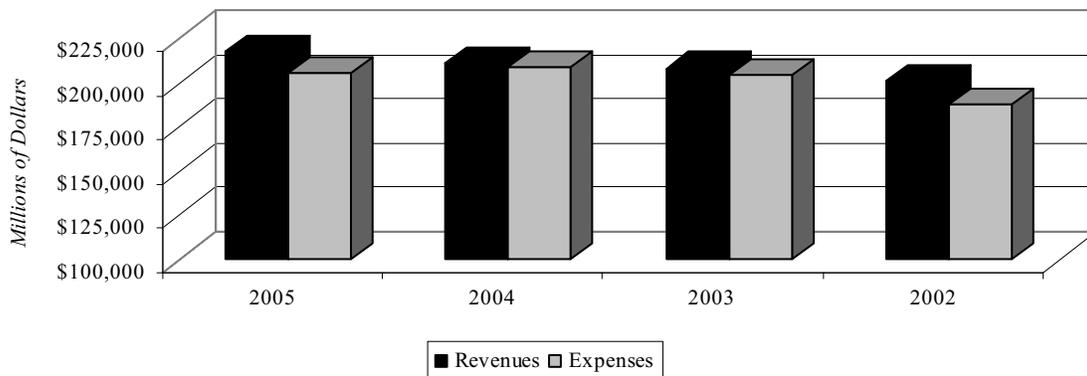
Total Salaries and Benefits Expense



For the years ended September 30, 2005, 2004 and 2003, the University reported an operating loss of approximately \$80,137,000, \$83,315,000 and \$81,812,000, respectively. Net operating losses are offset by state appropriations which are included as nonoperating revenue. After adding state appropriations and other nonoperating revenues and expenses, (primarily capital contributions and additions to endowment) the total increase in net assets was approximately \$21,846,000, \$15,918,000 and \$8,871,000 for the years ended September 30, 2005, 2004 and 2003, respectively.

The Hospitals represent approximately half of total University revenues and expenses, which have remained relatively constant over the past four years. Operating hospital revenues and expenses for the last four fiscal years have not changed significantly and are presented below:

Hospital Operating Revenues and Expenses



UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

Statement of Cash Flows

The statement of cash flows presents information related to cash flows of the University. This statement presents cash flows by category: operating activities, noncapital financing activities, capital and related financing activities and investing activities. The net cash provided to, or used by, the University is presented by category.

Capital Assets and Debt Administration

Total capital asset additions for the University were approximately \$33,000,000, \$23,000,000 and \$26,000,000 during the years ended September 30, 2005, 2004 and 2003, respectively. Significant capital asset additions in fiscal 2005 included the Student Services Building, Building II in the USA Technology and Research Park, infrastructure construction at the Park and the renovation of the University's baseball stadium. Significant projects in fiscal 2003 and 2004 included Building I in the USA Research Park, JagTran (the campus shuttle system) and new student intramural athletic facility and a number of campus and hospital renovation projects. There were no major dispositions of capital assets in 2005, however, there were two major dispositions of capital assets in 2004. The initial building of the USA Technology and Research Park was sold to the USA Research and Technology Corporation and a former dormitory located at 1500 Government Street was sold to an unrelated party. The total proceeds from these sales were approximately \$11,900,000. At September 30, 2005, the University has outstanding commitments of approximately \$14,400,000 for various capital projects.

No new long-term debt was issued during 2005. During 2004, the University issued its University Tuition Revenue Refunding and Capital Improvement Bonds, Series 2004, with a face value of \$51,080,000. The proceeds from the issuance of the bonds, issued at a premium of approximately \$2,300,000, were used to refund the Hospital and Auxiliary Revenue Refunding Bonds, Series 1993 (\$21,790,000). Additionally, approximately \$30,000,000 is being used to fund construction and other capital improvements at the University. Additionally, the University's capital lease obligation was fully paid in 2004.

During the year ended September 30, 2005, the University's bond credit rating was unchanged at Moody's A2. The University bond credit rating was upgraded in both 2003 and 2004.

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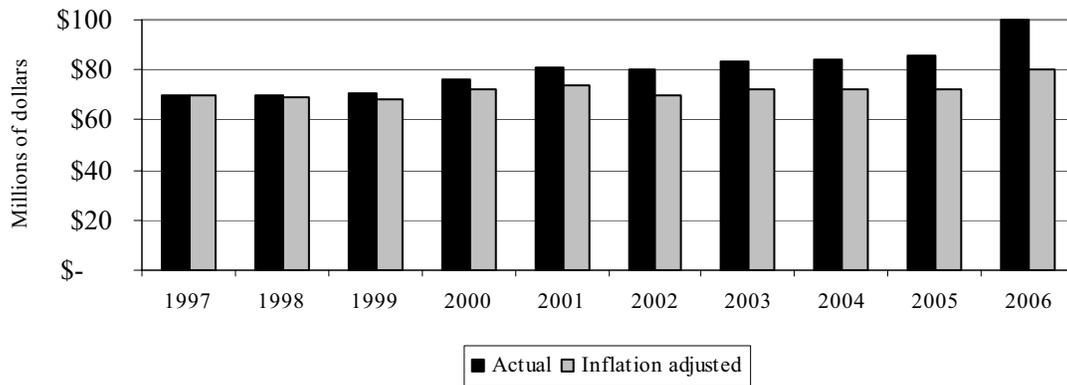
Management's Discussion and Analysis (Unaudited)

September 30, 2005 and 2004

Economic Outlook

While enrollment and tuition have both increased in recent years, state appropriations have historically been relatively flat. For the 2006 state budget year, however, regular appropriations increased by approximately \$13,500,000 or 16%.

State Appropriations - Ten Year History



University administration is not aware of any other currently known facts, decisions, or conditions, except as noted below, that are expected to have a significant effect on the University's financial position or results of operations during fiscal year 2006 beyond those unknown variables having a global effect on virtually all types of business operations.

In August 2005, the University and Infirmiry Health System, Inc. (IHS) entered into a memorandum of understanding regarding the development of a formal relationship between the University and IHS. The provisions of the memorandum include, among other things, the execution of a long-term lease of the University's Knollwood Hospital to IHS and the relocation of the University's Cancer Research Institute to property procured by the University adjacent to the USA Children's and Women's Hospital and Mobile Infirmiry. University management anticipates that this agreement will become effective during the year ending September 30, 2006.



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Independent Auditors' Report on Basic Financial Statements and Schedule of Expenditures of Federal Awards

The Board of Trustees
University of South Alabama:

We have audited the accompanying basic financial statements of the University of South Alabama, a component unit of the State of Alabama, (the University) and its aggregate discretely presented component units as of and for the years ended September 30, 2005 and 2004, as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express opinions on these financial statements based on our audits. We did not audit the 2005 and 2004 consolidated financial statements of the University of South Alabama Foundation, which represents 91%, 100% and 21%, respectively, of the 2005 assets, net assets and revenues of the aggregate discretely presented component units and 94%, 100% and 48%, respectively, of the 2004 assets, net assets and revenues of the aggregate discretely presented component units. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the University of South Alabama Foundation, is based on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. The financial statements of the University of South Alabama Foundation, the University of South Alabama Health Services Foundation and the Professional and General Liability Trust Funds were not audited in accordance with *Government Auditing Standards*. 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 and the report of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the University and of its aggregate discretely presented component units as of September 30, 2005 and 2004, and the respective changes in financial position and cash flows, where applicable, thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.



As disclosed in note 1 to the financial statements, as of October 1, 2004, the University adopted the provisions of Governmental Accounting Standards Board (GASB), Statement No. 40, *Deposit and Investment Risk Disclosures*, and as of October 1, 2003, adopted the provisions of GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*.

The management's discussion and analysis on pages 1 through 10 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 11, 2005, on our consideration of the University'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.

Our audits were conducted for the purpose of forming opinions on the financial statements that collectively comprise the University's basic financial statements. The accompanying Schedule of Expenditures of Federal Awards for the year ended September 30, 2005 is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. The schedule of Expenditures of Federal Awards has been subjected to the auditing procedures applied in the audit of the 2005 basic financial statements and, in our opinion, is fairly stated in the all material respects in relation to the 2005 basic financial statements taken as a whole.

KPMG LLP

November 11, 2005

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Statements of Net Assets

September 30, 2005 and 2004

(In thousands)

	2005	2004
Assets:		
Current assets:		
Cash and cash equivalents	\$ 33,818	41,189
Investments	74,490	65,666
Net patient accounts receivable, (net of allowance for doubtful accounts of \$48,922 and \$42,397)	32,201	28,744
Accounts receivable, affiliates	9,451	10,038
Accounts receivable, other	13,749	10,105
Notes receivable, net	385	452
Prepaid expenses, inventories, and other	6,325	5,737
Total current assets	170,419	161,931
Noncurrent assets:		
Restricted cash and cash equivalents	8,272	9,307
Restricted investments	49,371	48,580
Investments	18,204	14,232
Notes receivable, net	3,935	4,435
Other noncurrent assets	4,758	4,928
Capital assets, net	231,027	216,767
Total noncurrent assets	315,567	298,249
Total assets	485,986	460,180
Liabilities:		
Current liabilities:		
Accounts payable and accrued liabilities	47,382	42,633
Deferred revenue	18,230	17,200
Deposits	964	624
Current portion of long-term debt	6,258	5,924
Total current liabilities	72,834	66,381
Noncurrent liabilities:		
Long-term debt, less current portion	120,875	125,885
Other long-term liabilities	36,321	33,804
Total noncurrent liabilities	157,196	159,689
Total liabilities	230,030	226,070
Net assets:		
Invested in capital assets, net of related debt	127,805	116,037
Restricted, nonexpendable:		
Scholarships	4,847	3,719
Other	7,361	6,653
Restricted, expendable:		
Scholarships	2,785	1,635
Other	7,212	5,515
Unrestricted	105,946	100,551
Total net assets	\$ 255,956	234,110

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statements of Financial Position

June 30, 2005 and 2004

(In thousands)

Assets	2005	2004
Cash and cash equivalents	\$ 1,920	2,235
Investments:		
Securities, at fair value	118,405	125,548
Timber and mineral properties	141,954	138,906
Real estate	17,256	16,475
Accounts receivable	420	447
Other assets	282	375
	\$ 280,237	283,986
	280,237	283,986
Liabilities and Net Assets		
Liabilities:		
Accounts payable	\$ 221	55
Contributions payable to the University of South Alabama	14	14
Notes payable	13,525	17,125
Other liabilities	776	1,189
	14,536	18,383
Net assets:		
Unrestricted	58,266	56,880
Temporarily restricted	43,089	44,632
Permanently restricted	164,346	164,091
	265,701	265,603
Total liabilities and net assets	\$ 280,237	283,986

See accompanying notes to financial statements.

**UNIVERSITY OF SOUTH ALABAMA
HEALTH SERVICES FOUNDATION**
(Discretely Presented Component Unit)

Statements of Financial Position

September 30, 2005 and 2004

(In thousands)

Assets	2005	2004
Current assets:		
Cash and cash equivalents	\$ 243	513
Investments	1,099	1,089
Patient accounts receivable (net of allowance for uncollectible accounts of approximately \$5,038 and \$4,549)	10,115	6,598
Other current assets	1,196	1,033
Total current assets	<u>12,653</u>	<u>9,233</u>
Assets limited as to use, held by trustee	12,165	9,031
Property and equipment, net	1,287	1,405
Total assets	<u>\$ 26,105</u>	<u>19,669</u>
Liabilities and Deficit		
Current liabilities:		
Accounts payable	\$ 948	813
Accrued payroll	178	240
Current portion of notes payable	838	855
Current portion of obligation under capital lease	52	47
Due to affiliates	9,223	6,221
Total current liabilities	<u>11,239</u>	<u>8,176</u>
Notes payable, less current portion	2,370	3,209
Obligation under capital lease, less current portion	47	103
Estimated professional liability costs	12,165	9,031
Total liabilities	<u>25,821</u>	<u>20,519</u>
Unrestricted net assets (deficit)	284	(850)
Total liabilities and net assets (deficit)	<u>\$ 26,105</u>	<u>19,669</u>

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Statements of Revenues, Expenses, and Changes in Net Assets

Years ended September 30, 2005 and 2004

(In thousands)

	2005	2004
Operating revenues:		
Tuition and fees (net of scholarship allowances of \$12,971 and \$13,026)	\$ 43,737	38,832
Net patient service revenue (net of provision for bad debts of \$74,529 and \$71,779)	219,006	211,124
Federal grants and contracts	31,110	34,326
State grants and contracts	6,614	3,887
Private grants and contracts	35,661	34,015
Auxiliary enterprises (net of scholarship allowances of \$363 and \$364)	14,891	14,572
Other operating revenues	13,431	10,495
Total operating revenues	364,450	347,251
Operating expenses:		
Salaries and benefits	307,039	292,089
Supplies and other services	105,116	106,564
Scholarships and fellowships	3,934	4,194
Utilities	9,837	9,785
Depreciation	18,661	17,934
Total operating expenses	444,587	430,566
Operating loss	(80,137)	(83,315)
Nonoperating revenues (expenses):		
State appropriations	86,622	84,233
Investment income	7,545	3,789
Interest expense	(5,750)	(5,490)
Other nonoperating revenues	4,076	3,912
Other nonoperating expenses	(207)	(404)
Net nonoperating revenues	92,286	86,040
Income before capital contributions and additions to endowment	12,149	2,725
Capital appropriations	50	950
Capital contributions and grants	8,783	9,377
Additions to endowment	864	2,866
Increase in net assets	21,846	15,918
Net assets:		
Beginning of year	234,110	218,192
End of year	\$ 255,956	234,110

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statement of Activities and Changes in Net Assets

Year ended June 30, 2005

(In thousands)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Revenues, gains, and other support:				
Net realized and unrealized gains (losses) on investments	\$ 9,292	(1,266)	40	8,066
Rents, royalties and timber sales	5,109	—	97	5,206
Interest and dividends	1,724	984	9	2,717
Gifts	2	149	55	206
Required match of donor contributions	(54)	—	54	—
Interfund interest	(3,645)	3,645	—	—
Net assets released from program restrictions	5,055	(5,055)	—	—
Total revenues, gains, and other support	<u>17,483</u>	<u>(1,543)</u>	<u>255</u>	<u>16,195</u>
Expenditures:				
Program services:				
Faculty support	2,631	—	—	2,631
Scholarships	1,019	—	—	1,019
Other	2,563	—	—	2,563
Total program service expenditures	<u>6,213</u>	<u>—</u>	<u>—</u>	<u>6,213</u>
Management and general	2,148	—	—	2,148
Other investment expense	1,300	—	—	1,300
Interest expense	907	—	—	907
Depreciation and depletion expense	5,529	—	—	5,529
Total expenditures	<u>16,097</u>	<u>—</u>	<u>—</u>	<u>16,097</u>
Increase (decrease) in net assets	1,386	(1,543)	255	98
Net assets – beginning of year	<u>56,880</u>	<u>44,632</u>	<u>164,091</u>	<u>265,603</u>
Net assets – end of year	<u>\$ 58,266</u>	<u>43,089</u>	<u>164,346</u>	<u>265,701</u>

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statement of Activities and Changes in Net Assets

Year ended June 30, 2004

(In thousands)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Revenues, gains, and other support:				
Net realized and unrealized gains on investments	\$ 24,741	10,347	325	35,413
Rents, royalties and timber sales	12,292	23	75	12,390
Interest and dividends	1,159	854	7	2,020
Gifts	3	1	1	5
Required match of donor contributions	(16)	—	16	—
Interfund interest	(2,382)	2,382	—	—
Net assets released from program restrictions	5,825	(5,825)	—	—
Total revenues, gains, and other support	<u>41,622</u>	<u>7,782</u>	<u>424</u>	<u>49,828</u>
Expenditures:				
Program services:				
Faculty support	2,344	—	—	2,344
Scholarships	1,009	—	—	1,009
Other	3,539	—	—	3,539
Total program service expenditures	<u>6,892</u>	<u>—</u>	<u>—</u>	<u>6,892</u>
Management and general	2,289	—	—	2,289
Other investment expense	1,381	—	—	1,381
Interest expense	1,302	—	—	1,302
Depreciation and depletion expense	13,361	—	—	13,361
Total expenditures	<u>25,225</u>	<u>—</u>	<u>—</u>	<u>25,225</u>
Increase in net assets	16,397	7,782	424	24,603
Net assets – beginning of year	<u>40,483</u>	<u>36,850</u>	<u>163,667</u>	<u>241,000</u>
Net assets – end of year	<u>\$ 56,880</u>	<u>44,632</u>	<u>164,091</u>	<u>265,603</u>

See accompanying notes to financial statements.

**UNIVERSITY OF SOUTH ALABAMA
HEALTH SERVICES FOUNDATION**
(Discretely Presented Component Unit)

Statements of Operations and Changes in Net Assets (Deficit)

Years ended September 30, 2005 and 2004

(In thousands)

	2005	2004
Unrestricted revenues, gains and other support:		
Net patient service revenue	\$ 51,680	46,151
Other revenue	6,688	6,163
Total unrestricted revenues, gains and other support	58,368	52,314
Expenses:		
Salaries and benefits	33,918	31,125
General and administrative	13,418	13,176
Provision for uncollectible accounts	10,377	9,289
Depreciation and amortization	621	578
Interest	157	144
Total expenses	58,491	54,312
Operating loss	(123)	(1,998)
Nonoperating revenue	276	253
Revenues over (under) expenses	153	(1,745)
Contributions restricted for debt service, received and expended within the same year	1,000	1,000
Unrealized loss on other than trading securities	(19)	(22)
Change in unrestricted net assets (deficit)	1,134	(767)
Deficit at beginning of year	(850)	(83)
Unrestricted net assets (deficit) at end of year	\$ 284	(850)

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Statements of Cash Flows

Years ended September 30, 2005 and 2004

(In thousands)

	2005	2004
Cash flows from operating activities:		
Receipts related to tuition and fees	\$ 44,083	40,103
Receipts from and on behalf of patients and third-party payers	215,243	210,071
Receipts from grants and contracts	71,650	70,926
Receipts related to auxiliary enterprises	14,860	14,592
Payments to suppliers and vendors	(103,923)	(119,651)
Payments to employees and related benefits	(309,840)	(291,864)
Payments for scholarships and fellowships	(3,934)	(4,193)
New loans issued to students	(1,162)	(1,075)
Student loan repayments	1,721	1,214
Other operating receipts	13,715	10,418
	<u>(57,587)</u>	<u>(69,459)</u>
Net cash used in operating activities		
Cash flows from noncapital financing activities:		
State appropriations	86,619	84,337
Endowment gifts	804	1,216
Agency funds received	761	770
Agency funds disbursed	(729)	(987)
Stafford and PLUS loans received	58,966	57,233
Stafford and PLUS loans disbursed	(58,768)	(57,217)
Other nonoperating revenues	3,489	3,912
Other nonoperating expenses	(127)	(2,903)
	<u>91,015</u>	<u>86,361</u>
Net cash provided by noncapital financing activities		
Cash flows from capital and related financing activities:		
Capital appropriations	50	950
Capital gifts and grants	8,639	7,199
Purchases of capital assets	(34,445)	(20,295)
Proceeds from sale of capital assets	423	11,838
Proceeds from issuance of capital debt	—	53,450
Principal payments on capital debt	(5,922)	(27,715)
Interest payments on capital debt	(4,481)	(4,910)
	<u>(35,736)</u>	<u>20,517</u>
Net cash provided by (used in) capital and related financing activities		
Cash flows from investing activities:		
Interest and dividends on investments	4,962	2,081
Purchases of investments	(236,497)	(122,432)
Proceeds from sales of investments	225,437	70,144
Receipt of deposits with Trustees	—	11,597
	<u>(6,098)</u>	<u>(38,610)</u>
Net cash used in investing activities		
Net decrease in cash and cash equivalents	(8,406)	(1,191)
Cash and cash equivalents (unrestricted and restricted):		
Beginning of year	50,496	51,687
End of year	<u>\$ 42,090</u>	<u>50,496</u>

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Statements of Cash Flows

Years ended September 30, 2005 and 2004

(In thousands)

	2005	2004
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	\$ (80,137)	(83,315)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation expense	18,661	17,934
Changes in assets and liabilities, net:		
Student receivables	(459)	(538)
Net patient accounts receivable	(2,095)	1,574
Grants and contracts receivables	(1,329)	(1,340)
Student loan program receivables	559	139
Other receivables	(2,983)	(1,961)
Prepaid expenses, inventories, and other	(597)	132
Accounts payable and accrued liabilities	9,762	(4,104)
Deferred revenue	1,031	2,020
Net cash used in operating activities	\$ (57,587)	(69,459)
Noncash investing, noncapital financing, and capital and related financing transactions:		
Increase in fair value of investments recognized as a component of investment income	\$ 1,430	233
Additional maturity on capital appreciation bonds payable recorded as interest expense	1,330	1,265
Gift of capital assets	—	1,698
Gift of remainder interest in real estate	—	1,649
Pledges of capital gifts	—	480
Capitalization of construction period interest	197	—

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Notes to Basic Financial Statements

September 30, 2005 and 2004

(1) Summary of Significant Accounting Policies

(a) Reporting Entity

The accompanying basic financial statements present the financial position and activities of the University of South Alabama (the University), which is a component unit of the State of Alabama.

The financial reporting entity, as defined by Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity* and amended by GASB Statement No. 39, *Determining Whether Certain Organizations Are Components Units*, consists of the primary government and all of its component units. Component units are legally separate organizations for which the primary government is financially accountable and other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the financial statements to be misleading or incomplete. Accordingly, the basic financial statements include the accounts of the University, as the primary government, and the accounts of the following entities as component units.

As of October 1, 2003, the University adopted GASB Statement No. 39 which provides criteria for determining whether certain organizations should be reported as component units based on the nature and significance of their relationship with the primary government. The statement also clarifies reporting requirements for those organizations. Based on these criteria, the University reports the University of South Alabama Foundation (USA Foundation) and the University of South Alabama Health Services Foundation (USAHSF) as discretely presented component units.

The University is also affiliated with the South Alabama Medical Science Foundation and USA Research and Technology Corporation. These entities are not considered component units of the University under the provisions of GASB Statement Nos. 14 and 39 (see note 12 for further discussion of these entities).

(b) Professional Liability and General Liability Trust Funds

GASB Statement No. 14 requires the University, as the primary government, to include in its financial statements, as a component unit, organizations that, even though they are legally separate entities, meet certain requirements as defined by GASB Statement No. 14. The medical malpractice liability of the University is maintained and managed in a separate professional liability trust fund (the PLTF) in which the University and USAHSF are the only participants. In accordance with the bylaws of the trust fund, the president of the University is responsible for appointing members of the trust fund policy committee. Additionally, the general liability of the University is maintained and managed in a general liability trust fund (the GLTF) for which the University, as defined by GASB Statement No. 14, is responsible. The PLTF and GLTF are separate legal entities which are governed by the University Board of Trustees through the University president. As such, PLTF and GLTF are reported as blended component units.

UNIVERSITY OF SOUTH ALABAMA
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Notes to Basic Financial Statements

September 30, 2005 and 2004

(c) *University of South Alabama Foundation*

The USA Foundation is a not-for-profit foundation that was organized for the purpose of promoting education, scientific research and charitable purposes, and to assist in developing and advancing the University in furthering, improving and expanding its properties, services, facilities, and activities. Because of the significance of the relationship between the University and the USA Foundation, the USA Foundation is considered a component unit of the University. The Board of Directors of the USA Foundation is not appointed or controlled by the University. The University receives distributions from the USA Foundation primarily for scholarship, faculty and other support. Total distributions received or accrued by the University for the years ended September 30, 2005 and 2004 were \$6,143,000 and \$6,826,000, respectively, and are primarily included in other nonoperating revenues and capital contributions and grants in the University's statements of revenues, expenses, and changes in net assets. The USA Foundation presents its financial statements in accordance with standards issued by the Financial Accounting Standards Board (FASB). The USA Foundation is reported in separate financial statements because of the difference in the financial reporting format for the USA Foundation. The USA Foundation has a June 30 fiscal year end which differs from the University's September 30 fiscal year end. In accordance with GASB Statement No. 14, this discretely presented unit has been included with the most recent fiscal year. The consolidated statements of financial position and the consolidated statements of activities and changes in net assets for the USA Foundation as of and for the years ended June 30, 2005 and 2004 are discretely presented following the statements of net assets and statements of revenues, expenses, and changes in net assets of the University.

(d) *University of South Alabama Health Services Foundation*

The USAHSF is a not-for-profit corporation that exists to provide a group medical practice for physicians who are faculty members of the University and to further medical education and research at the University. Because of the significance of the relationship between the University and USAHSF, USAHSF is considered a component unit of the University. The USAHSF reimburses the University for salaries, certain administrative expenses and other support services. Total amounts received and accrued for such expenses were approximately \$28,959,000 and \$27,280,000 for the years ended September 30, 2005 and 2004, respectively, and are reflected as private grants and contracts in the accompanying statements of revenues, expenses, and changes in net assets of the University. The USAHSF presents its financial statements in accordance with standards issued by the FASB. The statements of financial position and the statements of operations and changes in unrestricted net assets (deficit) for the USAHSF for the years ended September 30, 2005 and 2004 are discretely presented following the statements of net assets and statements of revenues, expenses, and changes in net assets of the University.

(e) *Measurement Focus and Basis of Accounting*

For financial reporting purposes, the University is considered a special purpose governmental agency engaged only in business type activities, as defined by GASB Statement No. 34. Accordingly, the University's basic financial statements have been presented using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned, and expenses are recorded when an obligation has been incurred.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Notes to Basic Financial Statements

September 30, 2005 and 2004

The University prepares its basic financial statements in accordance with accounting principles generally accepted in the United States of America, as prescribed by GASB, including all applicable effective statements of the GASB and all statements of the FASB issued through November 30, 1989 that do not conflict with GASB pronouncements. The University has elected not to apply the provisions of any pronouncements of the FASB issued after November 30, 1989.

(f) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires that management make estimates and assumptions affecting the reported amounts of assets and liabilities, revenues and expenses, as well as disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

In particular, laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates related to these programs could change by a material amount in the near term.

(g) Cash and Cash Equivalents

Cash and cash equivalents are defined as petty cash, demand accounts and any short-term investments that take on the character of cash. These investments generally, but not always, have maturities of less than three months and include repurchase agreements and money market accounts.

(h) Investments and Investment Income

Investments are recorded at fair value. Investments received by gift are recorded at fair value at the date of receipt. Changes in the fair value of investments are reported in investment income.

(i) Accounts Receivable

Accounts receivable primarily result from net patient service revenue. Accounts receivable from affiliates primarily represent amounts due from USAHSF. Accounts receivable - other includes amounts due from students, the federal government, state and local governments, or private sources in connection with reimbursement of allowable expenditures made pursuant to the University's grants and contracts. Accounts receivable are recorded net of estimated uncollectible amounts.

(j) Inventories

The University's inventories primarily consist of bookstore inventories and medical supplies and pharmaceuticals. Bookstore inventories are valued at the lower of cost (moving average basis) or market. Medical supplies and pharmaceuticals are stated at the lower of cost (first-in, first-out method) or market.

(k) Capital Assets

Capital assets are recorded at cost, if purchased, or at fair value at date of donation. Depreciation is provided over the useful life of each class of depreciable asset using the straight-line method. Major renewals and renovations are capitalized. Costs for repairs and maintenance are expensed when

UNIVERSITY OF SOUTH ALABAMA
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Notes to Basic Financial Statements

September 30, 2005 and 2004

incurred. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and the gain or loss, if any, is included in nonoperating revenues (expenses) in the statements of revenues, expenses, and changes in net assets.

All capital assets other than land are depreciated using the following asset lives:

Buildings and infrastructure	40 to 50 years
Fixed equipment	10 to 20 years
Land improvements	8 to 20 years
Library materials	10 years
Other equipment	4 to 15 years

Interest costs, net of any related investment earnings, for certain assets constructed are capitalized as a component of the cost of acquiring those assets.

(l) *Deferred Revenue*

Student tuition, fees, and dormitory rentals are deferred and recognized over the applicable portion of each school term.

(m) *Classification of Net Assets*

The University's net assets are classified as follows:

Invested in capital assets, net of related debt represents the University's total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such debt is excluded from the calculation of *invested in capital assets, net of related debt*.

Restricted, nonexpendable net assets consist of endowment and similar type funds which donors or other outside sources have stipulated, as a condition of the gift instrument, the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may either be expended or added to principal.

Restricted, expendable net assets include resources that the University is legally or contractually obligated to spend in accordance with restrictions imposed by external parties.

Unrestricted net assets represent resources derived from student tuition and fees, state appropriations, net patient service revenue, sales and services of educational activities and auxiliary enterprises. Auxiliary enterprises are substantially self-supporting activities that provide services for students, faculty, and staff. While unrestricted net assets may be designated for specific purposes by action of management or the Board of Trustees, they are available for use at the discretion of the governing board, to meet current expenses for any purpose. Substantially all unrestricted net assets are designated for academic and research programs and initiatives, and capital programs.

UNIVERSITY OF SOUTH ALABAMA
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Notes to Basic Financial Statements

September 30, 2005 and 2004

When an expense is incurred that can be paid using either restricted or unrestricted resources, the University addresses each situation on a case-by-case basis prior to determining the resources to be used to satisfy the obligation.

(n) *Scholarship Allowances and Student Financial Aid*

Student tuition and fees, and certain other revenues from students, are reported net of scholarship discounts and allowances in the statements of revenues, expenses, and changes in net assets. Scholarship discounts and allowances are the difference between the stated charge for goods and services provided by the University and the amount that is paid by students and/or third parties making payments on the students' behalf. Certain governmental grants, such as Pell grants and other federal, state, or nongovernmental programs are recorded as either operating or nonoperating revenues in the University's basic financial statements based on their classification as either an exchange or nonexchange transaction. To the extent that revenues from such programs are used to satisfy tuition and fees and certain other student charges, the University has recorded a scholarship discount and allowance.

(o) *Donor Restricted Endowments*

The University is subject to the "Uniform Management of Institutional Funds Act (UMIFA)" of the Code of Alabama. This law allows the University, unless otherwise restricted by the donor, to spend net appreciation, realized and unrealized, on the endowment. The University's endowment spending policy provides that 5% of the three-year invested net asset moving average value (inclusive of net realized and unrealized gains and losses), as measured at September 30, is available annually for spending. The University's policy is to retain the endowment net interest and dividend income and net realized and unrealized appreciation with the endowment after distributions allowed by the spending policy have been made. These amounts, unless otherwise directed by the donor, are included in restricted, expendable net assets.

(p) *Classification of Revenues*

The University has classified its revenues as either operating or nonoperating revenues.

Operating revenues include activities that have the characteristics of exchange transactions such as student tuition and fees, net of scholarship discounts and allowances; sales and services of auxiliary enterprises, net of scholarship allowances; most federal, state, and local grants and contracts; and, net patient service revenue.

Nonoperating revenues include activities that have the characteristics of nonexchange transactions, such as gifts and contributions, and other revenue sources such as state appropriations, investment income, and gifts.

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Notes to Basic Financial Statements

September 30, 2005 and 2004

(q) Gifts and Pledges

Pledges of financial support from organizations and individuals representing an unconditional promise to give are recognized in the basic financial statements once all eligibility requirements, including time requirements, have been met. In the absence of such a promise, revenue is recognized when the gift is received. Endowment pledges generally do not meet eligibility requirements, as defined by GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions* and are not recorded as assets until the related gift has been received. Unconditional promises that are expected to be collected in future years are recorded at the present value of the estimated future cash flows.

(r) Grants and Contracts

The University has been awarded grants and contracts for which funds have not been received or expenditures made for the purpose specified in the award. These awards have not been reflected in the basic financial statements, but represent commitments of sponsors to provide funds for specific research or training projects. For grants that have allowable cost provisions, the revenue will be recognized as the related expenditures are made. For grants with work completion requirements, the revenue is recognized as the work is completed. For grants without either of the above requirements, the revenue is recognized as it is received.

(s) Net Patient Service Revenue

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payers and others for healthcare services rendered, including estimated retroactive reserve adjustments due to future audits, reviews and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered and such amounts are adjusted in future periods, as adjustments become known or as years are no longer subject to such audits, reviews and investigations.

(t) Costs of Borrowing

Debt financing costs and bond premium and discounts are deferred and amortized using the straight-line method, which approximates the effective interest rate method, over the term of the related bond issue.

(u) Compensated Absences

The University accrues annual leave for employees as incurred at rates based upon length of service and job classification.

(v) Reclassifications

Certain amounts in the 2004 basic financial statements have been reclassified in order to conform to the 2005 classification.

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Notes to Basic Financial Statements

September 30, 2005 and 2004

(2) Income Taxes

The University is classified as both a governmental entity under the laws of the State of Alabama and as a tax-exempt entity under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(3). Consistent with that designation, no provision for income taxes has been made in the accompanying basic financial statements.

(3) Cash

Pursuant to the Security for Alabama Funds Enhancement Act, funds on deposit may be placed in an institution designated as a qualified public depository (QPD) by the State of Alabama. QPD institutions pledge securities to a statewide collateral pool administered by the State Treasurer's office. Such financial institutions contribute to this collateral pool in amounts proportionate to the total amount of public fund deposits at their respective institutions. The securities are held at the Federal Reserve Bank and are designated for the State of Alabama. Additional collateral was not required for University funds on deposit with QPD institutions. At September 30, 2005, the net public deposits subject to collateral requirements for all institutions participating in the pool totaled approximately \$6,386,384,000. The University had cash and cash equivalents totaling \$42,090,000 and \$50,496,000 at September 30, 2005 and 2004, respectively.

(4) Investments

(a) *University of South Alabama*

The investments of the University are invested pursuant to the University of South Alabama "Non-endowment Cash Pool Investment Policies" and the "Endowment Fund Investment Policy" (collectively referred to as the "University Investment Policies") as adopted by the Board of Trustees. The purpose of the non-endowment cash pool investment policy is to provide guidelines by which pooled funds not otherwise needed to meet daily operational cash flows can be invested to earn a maximum return, yet still maintain sufficient liquidity to meet fluctuations in the inflows and outflows of University operational funds. Further, endowment fund investment policies exist to provide earnings to fund specific projects of the endowment fund, while preserving principal. The University Investment Policies require that management apply the "prudent person" standard in the context of managing its investment portfolio.

The investments of the blended component units of the University are invested pursuant to the separate investment policy of the PLTF and GLTF (the "Trust Fund Investment Policy.") The objectives of the Trust Fund Investment Policy are to provide a source of funds to pay general and professional liability claims and to achieve long-term capital growth to help defray future funding requirements. Additionally, investment of the University's component units both blended and discretely presented are subject to UMIFA as well as any requirements placed on them by contract or donor agreements.

Certain investments, primarily related to the University's endowment assets, are pooled. The University uses this pool to manage its investments and distribute investment income to individual endowment funds. Certain disclosures related to investment risk are presented only for investments outstanding at September 30, 2005. Investment risk at September 30, 2004 has not been evaluated.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Notes to Basic Financial Statements

September 30, 2005 and 2004

Investments of the University, by type, at fair value, are as follows at September 30, 2005 and 2004 (in thousands).

	2005	2004
U. S. Treasury notes	\$ 10,686	—
U. S. federal agency notes	78,708	106,974
Commercial paper	23,654	—
Pooled equity mutual funds	20,038	16,606
Pooled debt mutual funds	2,143	3,818
Managed income alternative investments	5,744	1,000
Collateralized mortgage obligations	701	—
Other	391	80
	\$ 142,065	128,478

At September 30, 2005 and 2004, \$1,828,000 and \$822,000, respectively, of appreciation in fair value of investments of donor-restricted endowments was recognized and are included in restricted expendable net assets in the accompanying statements of net assets.

Credit Risk

The University Investment Policies limit investment in corporate bonds to securities with a minimum “A” rating, at the time of purchase, by both Moody’s and Standard and Poor’s. Investments in corporate paper are limited to issuers with a minimum quality rating of P-1 by Moody’s, A-1 by Standard and Poor’s or F-1 by Fitch.

The University’s exposure to credit risk at September 30, 2005 is as follows:

	Credit rating	% of total investments
Federal National Mortgage Association	AAA	24.70%
Federal Home Loan Mortgage Corporation	AAA	22.80%
G. E. Capital Corporation	A-1	9.00%
Federal Home Loan Bank Corporation	AAA	4.80%
Citigroup Funding, Inc.	A1+	4.20%
Toyota Motor Credit Corporation	A1+	3.50%
Federal Farm Credit Banks Funding Corporation	AAA	3.30%
Common Fund pooled debt fund	AA	1.50%
Government National Mortgage Association	AAA	0.30%

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Notes to Basic Financial Statements

September 30, 2005 and 2004

Concentration of Credit Risk

At September 30, 2005, more than five percent of the University's investments were invested in the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and G. E. Capital Corporation. These investments represent approximately 25%, 23%, and 9% of the University's investments, respectively, and 23%, 21%, and 8% of the University's cash, cash equivalents and investments. The University Investment Policies require that not more than 10% of the cash, cash equivalents and investments of the University be invested in the obligations of a single private corporation and not more than 35% of the cash, cash equivalents and investments of the University be invested in the obligations of a single government agency.

Interest Rate Risk

At September 30, 2005, the maturity dates of the University's debt investments were as follows (in thousands):

	Fair Value	Years to Maturity			
		Less than 1	1-5	6-10	More than 10
U. S. Treasury notes	\$ 10,686	4,606	6,080	—	—
U. S. Federal agency notes	78,708	67,567	10,800	244	97
Collateralized mortgage obligations	701	—	9	—	692
Commercial paper	23,654	23,654	—	—	—
Pooled debt mutual funds	2,143	—	2,143	—	—
	<u>\$ 115,892</u>	<u>95,827</u>	<u>19,032</u>	<u>244</u>	<u>789</u>

Because the debt mutual funds had a weighted average maturity of 4.4 years at September 30, 2005, the investment was presented in the 1-5 year maturity category.

The University's Investment Policies do not specifically address the length to maturity on investments which the University must follow, however, it does require that the maturity range of investments be consistent with the liquidity requirements of the University.

Mortgage-Backed Securities

The University invests in mortgage-backed securities issued by the Government National Mortgage Association (GNMA) and the Federal National Mortgage Association (FNMA), agencies of the United States government. The University invests in these securities to increase the yield and return on its investment portfolio given the available alternative investment opportunities.

The fair value of mortgage-backed securities is generally based on the cash flows from principal and interest receipts on the underlying mortgage pools. These securities include collateralized mortgage obligations (CMOs). In CMOs, the cash flow from principal and interest payments from one or more mortgage pass-through securities or a pool of mortgages may be reallocated to multiple security classes with different priority claims and payment streams (commonly referred to as tranches). A holder of the CMO security thus chooses the class of security that best meets its risk and return objectives. CMOs are subject to significant market risk due to fluctuations in interest rates, prepayment rates and various liquidity factors related to their specific markets.

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(b) University of South Alabama Foundation

Investments in securities consist primarily of marketable equity securities totaling \$118,405,000 and \$125,548,000, at June 30, 2005 and 2004, respectively.

Investment income was comprised of the following for the years ended June 30, 2005 and 2004 (in thousands):

	2005	2004
Unrealized gains	\$ 853	30,563
Realized gains	7,213	4,850
Timber sales	4,533	11,857
Interest and dividends	2,717	2,020
Rents	494	380
Royalties	179	153
	\$ 15,989	49,823

Investment related expenses in the amount of \$358,000 and \$359,000, respectively, are included in the USA Foundation's management and general expenses in the accompanying 2005 and 2004 consolidated statements of activities and changes in net assets.

Real estate at June 30, 2005 and 2004 consisted of the following property held (in thousands):

	2005	2004
Land and land improvements – held for investment	\$ 15,035	14,018
Building and building improvements – held for investment	5,072	5,064
	20,107	19,082
Less accumulated depreciation	2,851	2,607
	\$ 17,256	16,475

Depreciation expense on real estate available for rent and occupied was \$245,000 and \$221,000 in 2005 and 2004, respectively.

Timber and mineral properties are stated at fair market value. Depletion of mineral properties is recognized over the remaining producing lives of the properties based on total estimated production and current period production. Depletion of timber properties is recognized on a specific identification basis as timber rights are sold or on a unit basis for sales made on that basis. Reforestation costs consisting of site preparation and planting of seedlings are capitalized.

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(5) Capital Assets

A summary of the University's capital asset activity for the year ended September 30, 2005 follows (in thousands):

	<u>Beginning balance</u>	<u>Additions</u>	<u>Transfers</u>	<u>Reductions</u>	<u>Ending Balance</u>
Capital assets not being depreciated:					
Land	\$ 23,774	112	—	—	23,886
Construction-in-progress	11,919	22,865	(6,706)	—	28,078
	<u>35,693</u>	<u>22,977</u>	<u>(6,706)</u>	<u>—</u>	<u>51,964</u>
Capital assets being depreciated:					
Land improvements	13,163	—	4,271	—	17,434
Buildings, fixed equipment, and infrastructure	284,924	125	672	(117)	285,604
Other equipment	90,649	7,800	1,763	(4,146)	96,066
Library materials	33,346	2,181	—	—	35,527
	<u>422,082</u>	<u>10,106</u>	<u>6,706</u>	<u>(4,263)</u>	<u>434,631</u>
Less accumulated depreciation for:					
Land improvements	(8,069)	(904)	—	—	(8,973)
Buildings, fixed equipment, and infrastructure	(147,211)	(7,424)	—	111	(154,524)
Other equipment	(61,429)	(8,636)	—	3,990	(66,075)
Library materials	(24,299)	(1,697)	—	—	(25,996)
	<u>(241,008)</u>	<u>(18,661)</u>	<u>—</u>	<u>4,101</u>	<u>(255,568)</u>
Capital assets being depreciated, net	<u>181,074</u>	<u>(8,555)</u>	<u>6,706</u>	<u>(162)</u>	<u>179,063</u>
Capital assets, net	<u>\$ 216,767</u>	<u>14,422</u>	<u>—</u>	<u>(162)</u>	<u>231,027</u>

At September 30, 2005, the University had commitments of approximately \$14,364,000 related to various construction projects.

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A summary of the University's capital asset activity for the year ended September 30, 2004 follows (in thousands):

	<u>Beginning balance</u>	<u>Additions</u>	<u>Transfers</u>	<u>Reductions</u>	<u>Ending Balance</u>
Capital assets not being depreciated:					
Land	\$ 23,849	—	—	(75)	23,774
Construction-in-progress	13,784	12,107	(13,972)	—	11,919
	<u>37,633</u>	<u>12,107</u>	<u>(13,972)</u>	<u>(75)</u>	<u>35,693</u>
Capital assets being depreciated:					
Land improvements	11,038	1	2,124	—	13,163
Buildings, fixed equipment, and infrastructure	282,806	3,348	11,848	(13,078)	284,924
Other equipment	87,378	5,571	—	(2,300)	90,649
Library materials	31,311	2,035	—	—	33,346
	<u>412,533</u>	<u>10,955</u>	<u>13,972</u>	<u>(15,378)</u>	<u>422,082</u>
Less accumulated depreciation for:					
Land improvements	(7,424)	(645)	—	—	(8,069)
Buildings, fixed equipment, and infrastructure	(140,509)	(7,362)	—	660	(147,211)
Other equipment	(55,114)	(8,314)	—	1,999	(61,429)
Library materials	(22,686)	(1,613)	—	—	(24,299)
	<u>(225,733)</u>	<u>(17,934)</u>	<u>—</u>	<u>2,659</u>	<u>(241,008)</u>
Capital assets being depreciated, net	<u>186,800</u>	<u>(6,979)</u>	<u>13,972</u>	<u>(12,719)</u>	<u>181,074</u>
Capital assets, net	<u>\$ 224,433</u>	<u>5,128</u>	<u>—</u>	<u>(12,794)</u>	<u>216,767</u>

At September 30, 2004, the University had commitments of approximately \$6,600,000 related to various construction projects.

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(6) Noncurrent Liabilities

A summary of the University's noncurrent liability activity for the years ended September 30, 2005 and 2004 follows (in thousands):

2005						
	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Less amounts due within one year</u>	<u>Noncurrent liabilities</u>
Long-term debt:						
Notes payable	\$ 5,875	—	(1,629)	4,246	1,378	2,868
Bonds payable	125,934	1,330	(4,377)	122,887	4,880	118,007
Total long-term debt	131,809	1,330	(6,006)	127,133	6,258	120,875
Other long-term liabilities	47,434	16,320	(12,530)	51,224	14,903	36,321
Total noncurrent liabilities	\$ 179,243	17,650	(18,536)	178,357	21,161	157,196
2004						
	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Less amounts due within one year</u>	<u>Noncurrent liabilities</u>
Long-term debt:						
Notes payable	\$ 7,549	—	(1,674)	5,875	1,629	4,246
Bonds payable	95,431	54,715	(24,212)	125,934	4,295	121,639
Capital lease obligations	1,829	—	(1,829)	—	—	—
Total long-term debt	104,809	54,715	(27,715)	131,809	5,924	125,885
Other long-term liabilities	23,755	44,488	(20,809)	47,434	13,630	33,804
Total noncurrent liabilities	\$ 128,564	99,203	(48,524)	179,243	19,554	159,689

Other long-term liabilities primarily consist of self-insurance liabilities and liabilities related to compensated absences. Amounts due within one year are included in accounts payable and accrued liabilities.

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(7) Notes and Bonds Payable

(a) University of South Alabama

Notes Payable

Notes payable consisted of the following at September 30, 2005 and 2004 (in thousands):

	2005	2004
Compass Bank limited obligation note, 2.743% payable through September 2008, unsecured	\$ 4,246	5,587
IBM Credit Corporation, 6.00% note payable, repaid in June 2005	—	288
	\$ 4,246	5,875

Bonds Payable

Bonds payable consisted of the following at September 30, 2005 and 2004 (in thousands):

	2005	2004
University Tuition Revenue Refunding Bonds, Series 1996, 3.80% to 5.00%, payable through November 2015	\$ 26,750	28,585
University Tuition Revenue Bonds, Series 1999 Current Interest, 3.70% to 4.35%, payable through November 2010	17,005	18,320
University Tuition Revenue Bonds, Series 1999 Capital Appreciation, 4.70% to 5.25%, payable November 2011 through November 2018	27,411	26,082
University Tuition Revenue Refunding and Capital Improvement Bonds, Series 2004, 2.00% to 5.00%, payable through March 2024	49,935	51,080
	121,101	124,067
Plus amortized premium	2,193	2,311
Less unamortized discount	(407)	(444)
	\$ 122,887	125,934

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Substantially all student tuition and fee revenues secure University bonds. Series 1996 Bonds began maturing November 2000, and are redeemable beginning May 2006, at varying premiums. Series 1999 Current Interest Bonds began maturing November 2002, and Capital Appreciation Bonds mature beginning November 2011. Series 1999 Bonds are not redeemable prior to maturity. Series 2004 Bonds began maturing in March 2005 and are redeemable beginning in March 2014.

During the years ended September 30, 2005 and 2004, the maturity value of the Capital Appreciation Bonds increased \$1,330,000 and \$1,265,000, respectively, over the original principal amount of \$19,810,000, reflecting accretion of interest.

During the year ended September 30, 2004, the University refunded the Series 1993 bonds with the proceeds from the issuance of the Series 2004 bonds. The 2004 refunding transaction resulted in an accounting loss totaling \$859,000, which has been deferred and is being amortized using the straight-line method through 2010. Aggregate cash flows from the refunding date through contractual maturity of the Series 1993 bonds totaled approximately \$25,669,000, while aggregate cash flows from refunding the Series 2004 bonds totaled approximately \$21,831,000, resulting in a positive net cash flow differential for the refunding of approximately \$3,838,000. The economic gain (generally defined as the present value of the net cash flow differential discounted at the effective interest rate of the new debt) on the 2004 refunding transaction totaled approximately \$3,427,000.

Approximately \$21,764,000 and \$29,982,000 of proceeds from the issuance of the Series 2004 Bonds remained unspent at September 30, 2005 and 2004, respectively. These amounts are included in restricted cash and cash equivalents (\$4,003,000 in 2005 and \$5,001,000 in 2004) and restricted investments (\$17,761,000 in 2005 and \$24,981,000 in 2004) on the statements of net assets and are restricted for capital purposes as outlined in the indenture.

The University defeased certain indebtedness during 1978 and 1984 by depositing funds in escrow trust accounts sufficient to provide for the subsequent payment of principal and interest on the defeased indebtedness. Neither the assets of the escrow trust accounts nor the defeased indebtedness is included in the accompanying statements of net assets. The principal outstanding on all defeased issues was \$9,040,000 at September 30, 2005.

The University is subject to restrictive covenants related to certain notes and bonds payable. At September 30, 2005, management believes the University was in compliance with such financial covenants.

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Debt Service on Long-term Obligations

Total debt service by fiscal year is as follows (in thousands):

	<u>Debt service on bonds</u>			<u>Debt service on notes</u>		
	<u>Principal</u>	<u>Interest</u>	<u>Additional maturity</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2006	\$ 4,880	5,749	(1,397)	1,378	99	10,709
2007	5,395	5,606	(1,469)	1,416	61	11,009
2008	5,830	5,438	(1,544)	1,452	21	11,197
2009	6,595	5,238	(1,622)	—	—	10,211
2010	7,315	5,005	(1,705)	—	—	10,615
2011-2015	37,855	20,735	(7,785)	—	—	50,805
2016-2020	39,670	12,061	(2,357)	—	—	49,374
2021-2025	31,440	3,242	—	—	—	34,682
Subtotal	138,980	<u>63,074</u>	<u>(17,879)</u>	<u>4,246</u>	<u>181</u>	<u>188,602</u>
Plus (less):						
Additional maturity	(17,879)					
Unamortized bond premium	2,193					
Unamortized bond discount	<u>(407)</u>					
Total	\$ <u>122,887</u>					

The principal amount of debt service due on bonds at September 30, 2005 includes \$17,879,000 representing additional maturity value on Series 1999 Capital Appreciation Bonds. These bonds mature in years 2011 through 2019 and are noninterest bearing. Although this additional maturity is presented as principal on the debt service schedule above, it is also recognized as interest expense on an annual basis in the University's financial statements as it accretes.

(b) University of South Alabama Foundation

The USA Foundation financed the purchase of timber property through issuance of a variable rate note payable to Regions Bank. The outstanding balance at June 30, 2005 and 2004 is \$12,900,000 and \$16,500,000, respectively.

The variable rate note is secured by timberland with a carrying value of \$97,858,000 at June 30, 2005 and contract rights for the sale of timber. The variable rate note has an interest rate at the London InterBank Offered Rate plus 0.75%, which was 4.09% and 2.11% at June 30, 2005 and 2004, respectively. Interest expense was approximately \$470,000 and \$413,000 for the years ended June 30, 2005 and 2004, respectively.

Future maturities of the note for years ending June 30 are as follows (in thousands):

2006	\$ 5,900
2007	<u>7,000</u>
	<u>\$ 12,900</u>

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On October 16, 2001, the USA Foundation entered into a five-year agreement with Regions Financial Corporation (the Counterparty), whereby the USA Foundation agreed to pay a fixed interest rate of 4.39% on the notional amount and the Counterparty agreed to pay the USA Foundation the excess of the variable rate interest due on the note to Regions Bank over the fixed interest with Regions Financial Corporation. Likewise, if the fixed interest exceeded the variable interest, then the USA Foundation would pay the excess to the Counterparty. At June 30, 2005 and 2004, the fair value of this swap agreement was an obligation of approximately \$81,000 and \$490,000, respectively. These amounts were included in the USA Foundation's other liabilities. For the years ended June 30, 2005 and 2004, the USA Foundation incurred interest expense of \$408,000 and \$853,000 on a notional amount approximating \$12,500,000 and \$19,500,000, respectively.

Interest rate swap agreements subject the USA Foundation to market risk associated with changes in interest rates as well as the risk that another party will fail to perform. Notional principal amounts often are used to express the volume of interest rate swap agreements, but the amounts potentially subject to credit risk are substantially less. In the opinion of management, the risk of loss in the event of significant market fluctuations or nonperformance by any counterparty under the derivative financial instrument is not significant.

On April 17, 2003, the Foundation financed the purchase of an office building through issuance of a fixed rate unsecured note payable to AmSouth Bank at 4.55% per annum that matures on April 1, 2006. The principal amount of the loan is due at maturity. Interest payments are due on the seventeenth day of each quarter. The outstanding balance at both June 30, 2005 and 2004 was \$625,000 and interest expense was approximately \$29,000 for both of the years ended June 30, 2005 and 2004.

(8) Capital Lease Obligation

On July 21, 1997, the University entered into a seven-year Lease Purchase Agreement as a method of financing the purchase of certain designated radiology equipment, a clinical information system, and other patient care-related equipment for the Hospitals. Assets totaling \$11,915,500 have been obtained through proceeds from the Lease Purchase Agreement as of September 30, 2004. This obligation was fully paid during the year ended September 30, 2004.

(9) Net Patient Service Revenue

The Hospitals have agreements with governmental and other third-party payers that provide for reimbursement at amounts different from their established rates. Contractual adjustments under third-party reimbursement programs represent the difference between the Hospitals' billings at established rates for services and amounts reimbursed by third-party payers.

A summary of the basis of reimbursement with major-third party payers follows:

Medicare – Substantially all acute-care services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary accordingly to patient classification systems that are based on clinical, diagnostic, and other factors. Additionally, the Hospitals are reimbursed for both direct and indirect medical education costs (as defined), principally based on per-resident prospective payment

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amounts and certain adjustments to prospective rate-per-discharge operating reimbursement payments. The Hospitals generally are reimbursed for certain retroactively settled items at tentative rates, with final settlement determined after submission of annual cost reports by the Hospitals and audits by the Medicare fiscal intermediary. The Hospitals' cost reports have been audited and settled for all fiscal years through 2003. Revenue from the Medicare program accounted for approximately 18% and 16% of the Hospitals' net patient service revenue for the years ended September 30, 2005 and 2004, respectively.

Blue Cross – Inpatient services rendered to Blue Cross subscribers are paid at a prospectively determined per diem rate. Outpatient services are reimbursed under a cost reimbursement methodology. For outpatient services, the Hospitals are reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the Hospitals and audits thereof by Blue Cross. The Hospitals' Blue Cross cost reports have been audited and settled for all fiscal years through 2003. Revenue from the Blue Cross program accounted for approximately 15% and 16% of the Hospitals' net patient service revenue for the years ended September 30, 2005 and 2004, respectively.

Medicaid – Inpatient services rendered to Medicaid program beneficiaries are reimbursed at all-inclusive prospectively determined per diem rates. Outpatient services are reimbursed based on an established fee schedule.

The Hospitals qualify as Medicaid essential providers and, therefore, also receive supplemental payments based on formulas established by the Alabama Medicaid Agency. There can be no assurance that the Hospitals will continue to qualify for future participation in this program or that the program will not ultimately be discontinued or materially modified.

Revenue from the Medicaid program accounted for approximately 36% and 28% of the Hospitals' net patient service revenue for the years ended September 30, 2005 and 2004, respectively.

Other – The Hospitals have also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The bases for payments to the Hospitals under these agreements include discounts from established charges and prospectively determined daily and case rates.

The composition of net patient service revenue for the years ended September 30, 2005 and 2004 follows (in thousands):

	2005	2004
Gross patient service revenue	\$ 415,306	407,059
Less provision for contractual and other adjustments	121,771	124,156
Less provision for bad debts	74,529	71,779
	\$ 219,006	211,124

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(10) Employee Benefits

(a) Retirement and Pension Plans

Employees of the University are covered by two pension plans: a cost sharing multiple-employer defined benefit pension plan administered by the Teachers' Retirement System of the State of Alabama (TRS), and a defined contribution pension plan.

Permanent employees of the University participate in TRS, a public retirement system created by an act of the State Legislature, with benefit provisions established by the Code of Alabama. Responsibility for general administration and operation of the TRS is vested in the Board of Control (currently 14 members). Benefits fully vest after 10 years of full-time, permanent employment. Vested employees may retire with full benefits at age 60 or after 25 years of service. Participating retirees may elect the maximum benefit, or may choose among four other monthly benefit options. Under the maximum benefit, participants are allowed 2.0125% of their average final salary (average of three highest years of annual compensation during the last ten years of service) for each year of service. The TRS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to the Retirement Systems of Alabama, P.O. Box 302150, Montgomery, Alabama 36130-2150, or by calling (334) 832-4140.

All employees covered by this retirement plan must contribute 5% of their eligible earnings to TRS. An actuary employed by the TRS Board of Control establishes the employer-matching amount annually. During 2005, 2004 and 2003, the University made total contributions of \$15,758,000, \$14,169,000, and \$10,467,000 (100% of the required contributions), respectively, to TRS on behalf of participants, which represents 7.03%, 6.56%, and 5.02%, respectively, of each participant's gross earnings. The University's payroll for all employees was approximately \$256,954,000 and \$241,357,000 in 2005 and 2004, respectively. Total payroll for University employees participating in the Teachers' Retirement System of Alabama was approximately \$224,158,000 and \$216,142,000 in 2005 and 2004, respectively.

The defined contribution pension plan covers certain academic and administrative employees, and participation by eligible employees is optional. Under this plan, administered by Teachers Insurance and Annuity Association – College Retirement Equities Fund (TIAA-CREF), contributions by eligible employees are matched equally by the University up to a maximum of 3% of current annual pay. The University and the employees each contributed \$789,000 and \$747,000 in 2005 and 2004, respectively, representing 428 and 412 employees participating in this Plan.

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(b) *Compensated Absences*

Regular University employees accumulate vacation and sick leave, subject to maximum limitations, at varying rates depending upon their employee classification and length of service. Upon termination of employment, employees are paid all unused accrued vacation at their regular rate of pay up to a maximum of two times their annual accumulation rate. The accompanying statements of net assets include accruals for vacation pay of approximately \$13,601,000 and \$12,671,000 at September 30, 2005 and 2004, respectively. No accrual is recognized for sick leave benefits since no terminal cash benefit is available to employees for accumulated sick leave.

(c) *Other Postretirement Employee Benefits*

In September 2003, the State of Alabama Legislature passed legislation that requires all colleges and universities to fund the healthcare premiums of its participating retirees. In prior years, such costs have been paid by the State. Beginning in October 2003, the University was assessed a monthly premium by the Public Education Employees' Health Insurance Plan (PEEHIP) based on the number of retirees in the system and an actuarially determined premium. During the years ended September 30, 2005 and 2004, the University's expense related to PEEHIP was \$3,548,000 and \$2,742,000, respectively.

(11) Risk Management

The University and USAHSF participate in the professional liability trust fund and the University participates in the general liability trust fund. Both funds are administered by an independent trustee. These trust funds are revocable and use contributions by the University and USAHSF, together with earnings thereon, to pay liabilities arising from the performance of its employees, trustees and other individuals acting on behalf of the University. If the trust funds are ever terminated, appropriate provision for payment of related claims will be made and any remaining balance will be distributed to the University and USAHSF in proportion to contributions made.

As discussed in note 1, the PLTF and GLTF are blended component units of the University, as defined by GASB Statement No. 14, and as such are included in the basic financial statements of the University for the years ended September 30, 2005 and 2004. Claims and expenses are reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. Those losses include an estimate of claims that have been incurred but not reported and the future costs of handling claims. These liabilities are generally based on actuarial valuations and are reported at their present value.

The University participates in a self-insured health plan, administered by an unaffiliated entity. Administrative fees paid by the University for such services were approximately \$1,155,000 and \$1,032,000 in 2005 and 2004, respectively. Contributions by the University and its employees, together with earnings thereon, are used to pay liabilities arising from healthcare claims. It is the opinion of University administration that plan assets are sufficient to meet future plan obligations.

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The changes in the total self-insurance liabilities for the years ended September 30, 2005 and 2004 for the PLTF, GLTF and health plan are summarized as follows (in thousands):

	2005	2004
Balance, beginning of year	\$ 31,623	9,917
Liabilities incurred and other additions	26,949	53,295
Claims, administrative fees paid and other reductions	(24,087)	(31,589)
Balance, end of year	\$ 34,485	31,623

(12) Other Related Parties

The South Alabama Medical Science Foundation (SAMSF) is a not-for-profit corporation that exists for the purpose of promoting education and research at the University. SAMSF reimburses the University for certain administrative expenses and other related support services. Total amounts received for such expenses were approximately \$770,000 and \$1,225,000 in 2005 and 2004, respectively, and are reflected as private grants and contracts in the accompanying statements of revenues, expenses, and changes in net assets.

The USA Research and Technology Corporation (the Corporation) is a not-for-profit corporation that exists for the purpose of furthering the educational and scientific mission of the University by developing, attracting, and retaining technology and research industries in Alabama that will provide professional and career opportunities to the University's students and faculty. During the year ended September 30, 2004, the University sold a building to the Corporation. The total amount received by the University for the building was \$10,513,000, resulting in no profit or loss to the University. Included in liabilities of the Corporation is a commercial mortgage note payable to Whitney National Bank, with annual interest of 6.00% payable monthly through January 2014. This note is not reflected in the University's statement of net assets nor is the note guaranteed by the University. The note payable is secured by a security interest in the ground lease with respect to the parcel of land on which the Corporation's building stands, a security interest in the Corporation's building, a security interest in tenant leases and a security interest in income received by the Corporation for rental of the building.

(13) Commitments and Contingencies

(a) Grants and Contracts

At September 30, 2005 and 2004, the University had been awarded approximately \$32,400,000 and \$32,542,000, respectively, in grants and contracts for which resources had not been received and for which reimbursable expenditures had not been made for the purposes specified. These awards, which represent commitments of sponsors to provide funds for research or training projects, have not been reflected in the accompanying basic financial statements as the eligibility requirements of the award have not been met. Advances include amounts received from grant and contract sponsors which have not been earned under the terms of the agreements and, therefore, have not yet been included in revenues in the accompanying basic financial statements. Federal awards are subject to audit by

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Notes to Basic Financial Statements

September 30, 2005 and 2004

Federal agencies. The University's management believes any adjustment from such audits will not be material.

(b) *Lines of Credit*

The University has established a \$10 million line of credit for general operating purposes with Regions Bank, with a variable interest rate of 0.480 percentage points over the London Interbank Offered Rate (LIBOR), not to exceed 6.9% (3.945% at September 30, 2005). No funds were advanced to the University from this credit line during the years ended September 30, 2005 and 2004.

In connection with the University's purchasing card program, the University has also established a \$2,000,000 line of credit with First Union National Bank, with a 0% interest rate. No funds were advanced under the line of credit at September 30, 2005 and 2004.

In connection with the Hospitals' participation in the State of Alabama Medicaid Program, the University has established a \$1,476,000 irrevocable standby letter of credit with Regions Bank with a variable interest rate of 0.480 percentage points over LIBOR, not to exceed 6.9%. The Alabama Medicaid Agency is the beneficiary of this letter of credit. No funds were advanced under this letter during the years ended September 30, 2005 and 2004.

(c) *Litigation*

Various claims have been filed against the University alleging discriminatory employment practices and other matters. University administration and legal counsel are of the opinion the resolution of these matters will not have a material effect on the financial position or the statement of revenues, expenses, and changes in net assets of the University.

In December 1999, the University and the State of Alabama entered into an "Agreement to Dismiss Litigation." This agreement called for the dismissal of the University's pending lawsuit against tobacco manufacturers in return for the payment of \$20,000,000 from the State to the University. The timing of the receipt of these funds is subject to availability. The payment is to be made over a period of not more than ten years. Pursuant to a separate agreement, 14% of all funds received are to be paid to the attorneys who represented the University in the litigation. At September 30, 2005, \$2,000,000 related to this settlement has been received and was recognized as state appropriations in prior years. Additionally, \$2,500,000 related to the settlement has been allocated to the University by the Alabama Public School and College Authority, all of which has been expended by the University as of September 30, 2005. Accordingly, \$15,500,000 of the original amount remained unpaid at September 30, 2005. At September 30, 2005, the \$15,500,000 has not been recorded in the University's basic financial statements because it is considered to be a contingent asset in accordance with FASB Statement No. 5.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Notes to Basic Financial Statements

September 30, 2005 and 2004

(14) Functional Information

Operating expenses by functional classification for the years ended September 30, 2005 and 2004 are listed below (in thousands). In preparing the basic financial statements, all significant transactions and balances among accounts have been eliminated.

	<u>2005</u>	<u>2004</u>
Instruction	\$ 84,870	72,931
Research	16,898	17,442
Public service	39,373	35,457
Academic support	15,406	12,257
Student services	16,828	15,086
Institutional support	15,612	15,291
Operation and maintenance of plant	13,484	13,248
Scholarships	1,129	1,715
Hospital	206,193	209,071
Auxiliary enterprises	13,792	13,546
Depreciation	18,661	17,934
Other	2,341	6,588
	<u>\$ 444,587</u>	<u>430,566</u>

(15) Significant New Accounting Pronouncements

In November 2003, the GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. GASB Statement No. 42 establishes accounting standards related to a significant and unexpected decline in the service utility of capital assets and clarifies and establishes the accounting requirements related to insurance recoveries and will be effective for the University for the year ending September 30, 2006. In June 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits (OPEB) other than Pensions*. GASB Statement No. 45 establishes standards for the measurement, recognition and disclosure of OPEB expenses and related liabilities and is effective for the University for the year ending September 30, 2008. In December 2004, the GASB issued Statement No. 46, *Net Assets Restricted by Enabling Legislation – an amendment of GASB Statement No. 34*. GASB Statement 46 clarifies reporting requirements on net assets that have been restricted by legally enforceable, enabling governmental legislation and will be effective for the University for the year ending September 30, 2006. In June 2005, the GASB issued Statement No. 47, *Accounting for Termination Benefits*. GASB Statement No. 47 establishes accounting standards for the recognition of a liability and expense for voluntary termination benefits and will be effective for the year ending September 30, 2006.

The effect of the implementation of GASB Statements Nos. 42, 45, 46 and 47 on the University has not been determined.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Notes to Basic Financial Statements

September 30, 2005 and 2004

(16) In August 2005, the University and Infirmity Health System, Inc. (IHS) entered into a memorandum of Subsequent Event

understanding regarding the development of a formal relationship between the University and IHS. The provisions of the memorandum were to execute a long-term lease of USA Knollwood Hospital to IHS, to relocate the USA Cancer Research Institute to property procured by the University from IHS near the Mobile Infirmity and USA Children's and Women's Hospital, and to expand the role of IHS in medical education. While certain costs may be required by the University related to the potential relocation of the USA Cancer Research Institute to the new location, such costs have not been recognized in the University's 2005 basic financial statements and will be recognized when a formal agreement between the parties is executed.

**SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
AND OMB CIRCULAR A-133 REPORTS**

UNIVERSITY OF SOUTH ALABAMA

Schedule of Expenditures of Federal Awards

Year ended September 30, 2005

Federal Grantor/ Pass-Through Grantor/ Program or Cluster Title	Federal CFDA Number	Federal Expenditures
Student Financial Aid Cluster*:		
U.S. Department of Education:		
Federal Pell Grant Program	84.063	\$ 8,805,845
Federal Supplemental Educational Opportunity Grant Program	84.007	848,580
Federal Family Educational Loan Program	84.032	59,082,140
Federal College Work Study Program	84.033	547,909
Federal Perkins Loan Program	84.038	1,157,803
Total U.S. Department of Education		<u>70,442,277</u>
Total Student Financial Aid Cluster		<u>70,442,277</u>
Research and Development Cluster*:		
Direct programs:		
U.S. Department of Health and Human Services:		
Biological Response to Environmental Health Hazard	93.113	514,201
Research Related to Deafness and Communicative Disorders	93.173	227,471
Centers for Disease Control and Prevention - Investigations and Technical Assistance	93.283	382,155
Comparative Medicine	93.306	323,702
Minority Health and Health Disparities Research	93.307	232,539
Bio-Medical Technology	93.371	(28)
Research Infrastructure	93.389	1,223,528
Academic Research Enhancement Award	93.390	14,768
Cancer Cause and Prevention Research	93.393	612,301
Cancer Detection and Diagnosis Research	93.394	46,981
Cancer Treatment Research	93.395	184,218
Cell Biology and Biophysics Research	93.821	116,028
Heart and Vascular Disease Research	93.837	1,339,355
Lung Disease Research	93.838	3,383,831
Blood Diseases and Resources Research	93.839	(34,123)
Diabetes Endocrinology and Metabolism Research	93.847	305,811
Extramural Research Programs in Neurosciences and Neurological Disorders	93.853	218,520
Microbiology and Infectious Diseases Research	93.856	1,915,436
Aging Research	93.866	498,620
Vision Research	93.867	573,046
Health Communities Access Programs Demonstration Authority	93.989	36,239
National Science Foundation:		
Mathematical and Physical Sciences	47.049	200,872
Geosciences	47.050	199,522
Biological Sciences	47.074	(2,789)
Social, Behavioral, and Economic Sciences	47.075	12,103
Polar Programs	47.078	140,013

UNIVERSITY OF SOUTH ALABAMA
Schedule of Expenditures of Federal Awards
Year ended September 30, 2005

Federal Grantor/ Pass-Through Grantor/ Program or Cluster Title	Federal CFDA Number	Federal Expenditures
Environmental Protection Agency: Environmental Protection Comprehensive Research Grants	66.500	\$ 666,829
U.S. Department of Commerce: Habitat Conservation	11.463	690,018
Centers for Disease Control: Squirrel Monkey	93.200-203- 01848	72,618
U.S. Department of Defense: Basic and Applied Scientific Research	12.300	34,261
Basic Scientific Research	12.431	71,015
Military Medical Research and Development	12.420	23,680
U.S. Department of Energy: Office of Science Financial Assistance Program	81.049	30,923
Renewal Energy Research and Development	81.087	529,496
U.S. Department of Transportation: University Transportation Centers Program	20.701	508,219
State and Community Highway Safety	20.600	(61)
U.S. Department of Interior: National Cooperative Geologic Mapping Program	15.810	1,530
U.S. Department of Agriculture: Competitive Research Grants	10.206	12,446
U.S. Department of Justice: National Institute for Juvenile Justice and Delinquency Prevention	16.542	920,566
Total direct programs		<u>16,225,860</u>

UNIVERSITY OF SOUTH ALABAMA
Schedule of Expenditures of Federal Awards
Year ended September 30, 2005

Federal Grantor/ Pass-Through Grantor/ Program or Cluster Title	Federal CFDA Number	Federal Expenditures
Pass-through programs:		
Pass-through from National Institutes of Health:		
Educational Development Center, Inc.	93.273	\$ 170
University of Pennsylvania	93.213	145,125
Sequella, Inc.	93.371	75,277
Mallard Medical, Inc.	93.838	1,276
Rockefeller University	93.839	14,184
Emory University	93.839	17,820
University of Miami	93.846	16,292
National Childhood Cancer Foundation	93.395	19,909
University of Texas	93.853	57,984
University of Alabama at Birmingham	93.865	(1,297)
University of Maryland	93.879	1,713
Pass-through from National Science Foundation:		
Florida State University	47.049	8,954
University of Georgia	47.074	2,923
University of Alabama	47.076	22,003
University of Alabama in Huntsville	47.076	16,447
Tuskegee University	47.076	41,459
Bigelow Laboratory for Ocean Sciences	47.078	52,169
University of Alabama	43.002	98,509
University of Alabama in Huntsville	43.002	(900)
Pass-through from U.S. Department of Commerce:		
University of Southern Mississippi	11.417	62,747
Alabama Department of Conservation and Natural Resources	11.419	204,299
Alabama Department of Emergency Management	11.419	13,136
Pass-through from U.S. Department of Interior:		
Alabama Department of Conservation and Natural Resources	15.605	57,243
Friends of Old Mobile	15.923	33,400
Louisiana State University	15.000	2,334
Pass-through from U.S. Department of Health and Human Services:		
Sickle Cell Foundation of Greater Montgomery	93.110	1,356
Sickle Cell Disease Association	93.110A	(26)
Northrop Grumman	93.243	134,735
Florida State University	93.969	12,357
Pass-through from U.S. Department of Transportation:		
Volkert and Associates, Inc.	20.205	3,800
University of Alabama at Birmingham	20.OGCA- 180122	46,725

UNIVERSITY OF SOUTH ALABAMA
Schedule of Expenditures of Federal Awards
Year ended September 30, 2005

Federal Grantor/ Pass-Through Grantor/ Program or Cluster Title	Federal CFDA Number	Federal Expenditures
Pass-through from U.S. Department of Energy:		
Oak Ridge Associated Universities	81.2328	\$ 1,070
Lawrence Livermore National Laboratory	81.B529446	41,530
University of Tennessee-Battelle, LLC	81.40000	
	313330	6,025
Pass-through from U.S. Department of Housing and Urban Development:		
The Mitchell Company	14.866	2,912
Mobile County Commission	14.228	12,888
Mobile Fair Housing Center	14.401	3,095
Pass-through from Environmental Protection Agency:		
Mobile Water and Sewer Service	66.606	59,419
Pass-through from Environmental Improvement Restoration Fund:		
Prince William Sound Science Center	93.09-PWSSC 02	37,558
Pass-through from Exxon Valdez Oil Spill Trustee Council:		
Prince William Sound Science Center	03.PHSSC-01	1,297
Prince William Sound Science Center	04.PWSSC-05	40,997
Pass-through from U.S. Department of Defense:		
University of Colorado	12.431	(2,111)
University of Washington	12.800	(205)
Naval Research Laboratory	12.300	(4)
Yale University	MDA-905-03- 1-TS12	187,387
Radiance Technologies, Inc.	12.630	428,019
Auburn University	12.431	34,774
Pass-through from NASA:		
University of Alabama in Huntsville	43.002	53
Total pass-through programs		<u>2,016,827</u>
Total Research and Development Cluster		<u>18,242,687</u>
Other federal assistance:		
Direct programs:		
U.S. Department of Education:		
TRIO Student Support Services	84.042A	147,850
Trio Talent Search	84.044A	273,855
Trio Upward Bound	84.047A	224,670

UNIVERSITY OF SOUTH ALABAMA
Schedule of Expenditures of Federal Awards
Year ended September 30, 2005

Federal Grantor/ Pass-Through Grantor/ Program or Cluster Title	Federal CFDA Number	Federal Expenditures
U.S. Department of Health and Human Services:		
Maternal and Child Health Federal Consolidated Programs	93.110	\$ 663,479
Rural Telemedicine Grants	93.211	32,727
Advanced Education Nursing Grant Programs	93.247	371,625
Advanced Education Nursing Traineeships	93.358	210,022
Basic Nurse Education and Practice Grants	93.359	328,099
U.S. Department of Energy:		
Office of Science Financial Assistance Program	81.049	2,245,856
Health Resources and Services Administration:		
Community Based Abstinence Education	93.010	116,887
Grants for Residency Training for General Pediatrics	93.884	56,482
Specially Selected Health Projects	93.888	536,463
Coordinated HIV Services and Access to Research for Children, Youth, Women and Families	93.153	315,677
National Institutes of Health:		
Medical Library Assistance	93.879	99
National Science Foundation:		
Education and Human Resources	47.076	89,593
Biological Sciences	47.074	95,103
U. S. Department of Housing and Urban Development		
Community Development Block Grants - Economic Development Initiative	14.246	462,261
Centers for Disease Control:		
Investigation and Technical Assistance	93.283	263,707
U.S. Department of Justice:		
Community Prosecution and Project Safe Neighborhoods	16.609	45,137
Byrne Formula Grant Program	16.579	10,110
U.S. Agency for International Development:		
USAID Foreign Assistance for Programs Overseas	98.001	286,065
U.S. Department of Transportation:		
National Motor Carrier Safety	20.218	352,937
Federal Transit – Capital Investment Grants	20.500	3,049,956
Americorp:		
Corporation of National and Community Service	94.006	20,131
Total direct programs		<u>10,198,791</u>

UNIVERSITY OF SOUTH ALABAMA
Schedule of Expenditures of Federal Awards
Year ended September 30, 2005

Federal Grantor/ Pass-Through Grantor/ Program or Cluster Title	Federal CFDA Number	Federal Expenditures
Pass-through programs:		
Pass-through from U.S. Department of Education:		
Alabama Department of Education	84.027	\$ 20,000
Lamar County Board of Education	84.027A	5,700
Alabama Department of Education	84.027A	(1,030)
Alabama Department of Education	84.323A	49,565
Alabama Department of Rehabilitation Services	84.181A	3,048
Alabama Commission on Higher Education	84.367B	119,313
Alabama Department of Education	84.366B	1,841,714
National Writing Project	84.928A	36,494
Alabama Department of Education	84.357A	(981)
Alabama Department of Education	84.367A	12,572
Mobile County Public Schools	84.010	29,813
Pass-through from NASA:		
Alabama Space Grant Consortium	43.002	(7,200)
University of Alabama in Huntsville	43.002	22,357
Pass-through from National Institutes of Health;		
Yale University	93.853	7,722
University of Alabama at Birmingham	93.856	92,720
University of Illinois	93.865	11,078
University of Maryland Baltimore	93.879	(180)
Pass-through from U.S. Department Defense:		
Mobile County Commission	12.300	20,796
Pass-through from U. S. Homeland Security:		
Mobile County Emergency Management Agency	04.030385-01	23,293
Pass-through from National Science Foundation		
Mobile Area Education Foundation	47.076	23,931
Pass-through from Small Business Administration:		
University of Alabama at Birmingham	59.037	119,351
Pass-through from U.S. Department of Justice:		
Mobile County Sheriff's Office	16.575	(25)
Alabama Department of Public Health	16.579	1,942
Mobile County Public Schools	16.585	11,953

UNIVERSITY OF SOUTH ALABAMA
Schedule of Expenditures of Federal Awards
Year ended September 30, 2005

Federal Grantor/ Pass-Through Grantor/ Program or Cluster Title	Federal CFDA Number	Federal Expenditures
Pass-through from U.S. Department of Health and Human Services:		
Alabama Department of Rehabilitative Services	93.110	\$ 6,838
Sickle Cell Foundation of Greater Montgomery	93.110A	1,870
Administration on Aging	93.048	9,950
University of Alabama	93.648	11,572
Alabama Department of Public Health	93.153	258,358
Alabama Department of Public Health	93.003	642,170
Alabama Department of Public Health	93.283	108,174
Total pass-through programs		3,482,878
Total other federal assistance		13,681,669
Total federal expenditures		\$ 102,366,633

* Denotes major program.

See accompanying notes to schedule of expenditures of federal awards.

See accompanying independent auditors' report on supplementary information.

UNIVERSITY OF SOUTH ALABAMA

Notes to Schedule of Expenditures of Federal Awards

September 30, 2005

(1) Basis of Presentation

The accompanying schedule of expenditures of federal awards includes the federal grant activity of University of South Alabama (the University) and is presented in accordance with accounting principles generally accepted in the United States of America. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

Expenditures listed on the accompanying schedule of expenditures of federal awards, except for Perkins Loans, Federal Family Educational Loan (FFEL) Programs, Parent Loans-PLUS loans, Loans to Disadvantaged Students and Health Education Assistance Loans (HEAL), represent actual expenditures incurred under the accrual basis of accounting for the year ended September 30, 2005. The loan programs representing loans made by the University are included in notes receivable in the accompanying 2005 statement of net assets and consist of the following:

Perkins loan program	\$ 4,025,610
Loans to disadvantaged students	9,661
Health professional loans	<u>230,643</u>
	4,265,914
Less outstanding balance of loans granted in previous years	<u>(3,108,111)</u>
New loans granted to eligible students of the University	<u><u>\$ 1,157,803</u></u>

The FFEL and HEAL federal awards represent loans received by students of the University during fiscal year 2005 which were not made by the University. Accordingly, FFEL and HEAL amounts are not reflected in the University's basic financial statements.

(2) Contingencies

These federal programs are subject to financial and compliance audits by grantor agencies which, if instances of material noncompliance are found, may result in disallowed expenditures and affect the University's continued participation in specific programs.

UNIVERSITY OF SOUTH ALABAMA

Notes to Schedule of Expenditures of Federal Awards

September 30, 2005

(3) Federal Family Education Loan Programs

During fiscal year ended September 30, 2005, the University processed the following amount of new loans under the Federal Family Education Loan Program:

	<u>CFDA#</u>		<u>Amount expended</u>
Subsidized Stafford loans	84.032	\$	25,544,560
Unsubsidized Stafford loans	84.032		29,987,544
Parents' loans for undergraduate students	84.032		<u>3,550,036</u>
Total		\$	<u><u>59,082,140</u></u>

(4) Administrative Cost Allowance

The accompanying schedule of expenditures of federal awards includes the following administrative costs:

Federal Work-Study	\$	131,433
Federal Perkins Loans		<u>2,134</u>
	\$	<u><u>133,567</u></u>

UNIVERSITY OF SOUTH ALABAMA

Notes to Schedule of Expenditures of Federal Awards

September 30, 2005

(5) Subrecipients

Of the federal expenditures presented in the schedule of expenditures of federal awards, the University provided federal awards to subrecipients under the following programs:

	<u>Federal CFDA #</u>		<u>Amounts expended</u>
Direct programs:			
Competitive Research Grants	10.206	\$	10,423
Habitat Conservation	11.463		145,818
University Transportation Center	20.701		2,450
Environmental Protection Comprehensive Research Grants	66.500		234,459
Community Based Abstience Education	93.010		82,829
Adolecesent Family Life Research Grants	93.110		513,949
Biological Response to Environmental Health Hazard	93.113		83,443
Coordinated Services for Access to Research for Women, Infants, Children and Youth	93.153		2,923
Heart and Vascular Disease Research	93.837		23,995
Lung Disease Research	93.838		82,683
Aging Research	93.866		43,490
Pass-through programs:			
U.S. Department of Health and Human Services/ Northrop Grumman	93.243		22,855
U. S. Department of Commerce/Alabama Department of Conservation and Natural Resources	11.419		37,617
U.S. Department of Interior/Friends of Old Mobile	15.923		9,290
U.S. Department of Health and Human Services/ Alabama Department of Public Health	81.087		179,222
U.S. Department of Health and Human Services/ Alabama Department of Public Health	93.003		42,762
U.S. Department of Health and Human Services/ Alabama Department of Public Health	93.283		6,094
U. S. Department of Education/Alabama Department of Education	84.366B		401,316
U. S. Department of Education/Alabama Commission on Higher Educations	84.367B		43,031
		\$	<u>1,968,649</u>



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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*

The Board of Trustees
University of South Alabama:

We have audited the basic financial statements of the University of South Alabama, a component unit of the State of Alabama, (the University) and its aggregate discretely presented component units as of and for the year ended September 30, 2005, and have issued our report thereon dated November 11, 2005. We did not audit the 2005 consolidated financial statements of the University of South Alabama Foundation, which represents 91%, 100% and 21%, respectively, of the 2005 assets, net assets and revenues of the aggregate discretely presented component units. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the University of South Alabama Foundation, is based on the report of the other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the University'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*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted certain matters that we have reported to management of the University in a separate letter dated November 11, 2005.



This report is intended solely for the information and use of the board of trustees, management, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 11, 2005



KPMG LLP
Suite 1100
One Jackson Place
188 East Capitol Street
Jackson, MS 39201

Independent Auditors' Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133

The Board of Trustees
University of South Alabama:

Compliance

We have audited the compliance of the University of South Alabama (the University) with the types of compliance requirements described in the *U. S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement (Compliance Supplement)* that are applicable to each of its major federal programs for the year ended September 30, 2005, except those requirements discussed in the third following paragraph. The University's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the University's management. Our responsibility is to express an opinion on the University's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the University's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the University's compliance with those requirements.

In our opinion, the University complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended September 30, 2005, other than those requirements discussed in the following paragraph. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as item 2005-1, 2005-2 and 2005-3.

We did not audit the University's compliance with requirements governing maintaining contact with and billing borrowers and processing deferment and cancellation requests and payments for the Federal Perkins Loan Program. Those requirements govern functions that are performed by Affiliated Computer Services, Inc. (ACS). Since we did not apply auditing procedures to satisfy ourselves as to compliance with those requirements, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on compliance with those requirements.



ACS's compliance with the requirements governing the functions that it performs for the University was examined by accountants for the servicer whose report has been furnished to us. The report of the accountants for the servicer indicates that compliance with those requirements was examined in accordance with the Department of Education's Audit Guide, *Compliance Audits (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*. Based on our review of the service organization accountants' report, we have determined that all of the compliance requirements included in the *Compliance Supplement* that are applicable to each of the major programs in which the University participates are addressed in either our report or the report of the service organization accountants. Further, based on our review of the service organization accountants' report, we have determined that it does not contain any findings of noncompliance that would have a direct and material effect on the University's major programs.

Internal Control Over Compliance

The management of the University is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the University's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Requirements governing maintaining contact with and billing borrowers and processing deferment and cancellation requests and payments for the Federal Perkins Loan Program are performed by ACS. Internal control over compliance relating to such functions was reported on by accountants for the servicer in accordance with the Department of Education's Audit Guide, *Compliance Audits (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*. A copy of the service organization accountants' report has been furnished to us. However, the scope of our work did not extend to internal control maintained at ACS.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the board of trustees, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 11, 2005

UNIVERSITY OF SOUTH ALABAMA

Schedule of Findings and Questioned Costs

Year ended September 30, 2005

I – Summary of Auditors’ Results

Financial Statements

Type of auditors’ report issued: Unqualified

Internal control over financial reporting:

Material weakness(es) identified? _____yes X no

Reportable condition(s) identified that are not considered to be material weaknesses? _____yes X none reported

Noncompliance material to financial statements noted? _____yes X no

Federal Awards

Internal control over major programs:

Material weakness(es) identified? _____yes X no

Reportable condition(s) identified that are not considered to be material weaknesses? _____yes X none reported

Type of auditors’ report issued on compliance for major program: Unqualified

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? _____X yes _____no

Identification of major programs:

<i>CFDA Numbers</i>	<i>Name of Federal Program or Cluster</i>
84.063, 84.007, 84.032, 84.033, 84.038	Student Financial Aid Cluster
Various	Research and Development Cluster

Dollar threshold used to distinguish between type A and type B programs: _____ \$3,000,000 _____

Auditee qualified as low-risk auditee? _____X yes _____no

Section II –Findings Related to Financial Statements Reported in
Accordance with *Government Auditing Standards*

There were no findings related to the financial statements reported in accordance with *Government Auditing Standards*.

UNIVERSITY OF SOUTH ALABAMA

Schedule of Findings and Questioned Costs

Year ended September 30, 2005

Section III – Federal Award Findings and Questioned Costs relating to Federal Awards

Finding No. 2005-01

Equipment and Real Property Management

Research and Development Cluster

Criteria

OMB Circular A-110 requires that property records contain the following information about equipment purchased with federal funds: description, source, title holders, acquisition date and cost, percentage of federal participation in the cost, location, condition and any ultimate disposal costs.

Condition

The University did not tag three federal equipment purchases.

Questioned Costs

None

Context

Three exceptions out of thirty items tested.

Effect

The University is not in compliance with federal policies regarding location of equipment and real property.

Recommendation

The University should carefully tag equipment purchases to ensure accurate information regarding equipment location.

Management Views

Management will re-emphasize the importance of ensuring that all capital assets purchased with federal funds are appropriately tagged.

Finding No. 2005-02

Cash Management

Research and Development Cluster

Criteria

The University should strengthen its internal control procedures related to cash management to ensure that federal funds are properly approved before being recorded in the general ledger.

Condition

The University did not properly document approval of the journal entries to record the federal drawdown before the journal entries were sent to the Business Office.

Questioned Costs

None

Context

During our review of the internal controls over cash management, thirty journal entries were reviewed to test proper approval and we noted sixteen exceptions, all of which were related to research and development expenditures.

Effect

The University is not in compliance with its internal control policies regarding documentation of approval of journal entries.

Recommendation

The University should ensure that appropriate personnel in Grants and Contracts Accounting review and document approval of journal entries before being sent to the Business Office for input into the general ledger.

Management Views

All journal entries noted above were approved prior to being input into the general ledger. The review on the sixteen items noted, however, was performed only by Business Office personnel. Management will implement procedures to ensure that journal entries are approved in Grants and Contracts Accounting and that these approvals are adequately documented prior to submitting the entries to the Business Office.

Finding No. 2005-03

Cash Management

Research and Development Cluster

Criteria

The University should strengthen its internal control procedures regarding documentation of approval of federal expenditure drawdown requests.

Condition

The University did not document approval of federal drawdowns before the drawdowns were requested.

Questioned Costs

None

Context

During our review of the internal controls over cash management, thirty drawdowns were reviewed to test proper approval. There were seventeen exceptions, all of which were related to research and development expenditures.

Effect

The University is not in compliance with its internal control policies regarding documentation of approval of federal expenditure drawdowns.

Recommendation

The University should ensure that appropriate personnel in Grants and Contracts Accounting review and document approval before each drawdown is requested.

Management Views

All drawdowns of federal funds are discussed with, and approved by, the Manager of Grants and Contracts Accounting prior to being made. Management will ensure that these approvals are adequately documented.