



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

Basic Financial Statements and Supplementary Information
on Federal Awards Programs

September 30, 2008

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

Basic Financial Statements
September 30, 2008 and 2007

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

Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

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, 2008 and 2007 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 note number 1 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, the University of South Alabama Health Services Foundation, and the USA Research and Technology Corporation are discretely presented.

Financial Highlights

At September 30, 2008, 2007, and 2006, the University had total assets of \$862,666,000, \$707,687,000, and \$545,649,000, respectively; total liabilities of \$454,339,000, \$323,171,000, and \$234,291,000, respectively; and net assets of \$408,327,000, \$384,516,000, and \$311,358,000, respectively. University net assets increased \$23,811,000 during the year ended September 30, 2008 compared to increases of \$73,158,000 and \$55,402,000 in the years ended September 30, 2007 and 2006, 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, 2008 and 2007. 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 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 patient accounts receivable. Of these amounts, cash and cash equivalents, investments, and patient accounts receivable comprise approximately 12%, 65%, and 9%, respectively, of current assets at September 30, 2008. Noncurrent assets at September 30, 2008 consist primarily of capital assets and restricted investments.

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

September 30, 2008 and 2007

The Condensed Schedule of Net Assets at September 30, 2008, 2007, and 2006 follows (in thousands):

Condensed Schedule of Net Assets

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Assets:			
Current	\$ 287,430	271,983	223,412
Capital assets	353,829	286,890	247,875
Other noncurrent	221,407	148,814	74,362
Total assets	<u>\$ 862,666</u>	<u>707,687</u>	<u>545,649</u>
Liabilities:			
Current	\$ 90,773	80,389	71,071
Noncurrent	363,566	242,782	163,220
Total liabilities	<u>\$ 454,339</u>	<u>323,171</u>	<u>234,291</u>
Net assets:			
Invested in capital assets, net of related debt	\$ 186,986	163,688	137,642
Restricted, nonexpendable	24,165	16,828	12,612
Restricted, expendable	23,071	35,955	25,966
Unrestricted	174,105	168,045	135,138
Total net assets	<u>\$ 408,327</u>	<u>384,516</u>	<u>311,358</u>

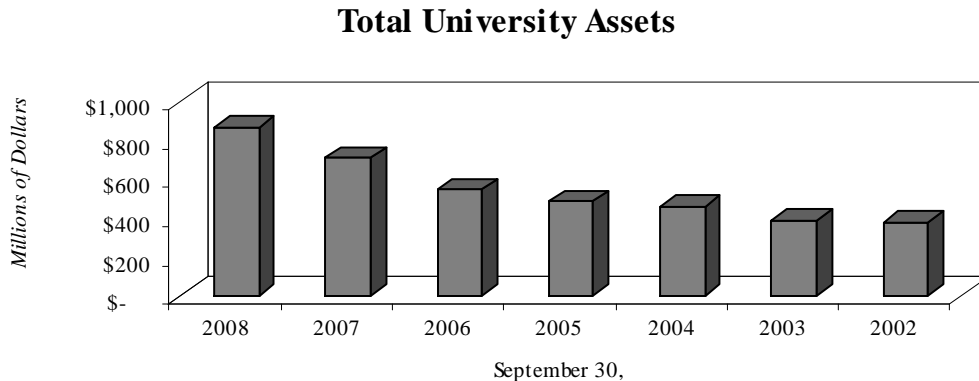
University cash, cash equivalents, and investments (current and noncurrent) increased between September 30, 2008 and 2007 by \$88,101,000 to \$423,748,000. This increase is due primarily to the issuance of additional bonded indebtedness during 2008. This follows a significant increase between 2006 and 2007, which resulted from cash generated by increases in state appropriations, the issuance of additional bonded indebtedness, investment income and gifts to the University.

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

September 30, 2008 and 2007

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



Noncurrent liabilities consist primarily of bonded indebtedness and notes payable. Long-term debt (including the current portion of long-term debt) increased from \$199,799,000 to \$316,326,000 between September 30, 2007 and 2008 primarily as a result of the issuance of additional bonded indebtedness and the sale of two swaptions by the University.

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.

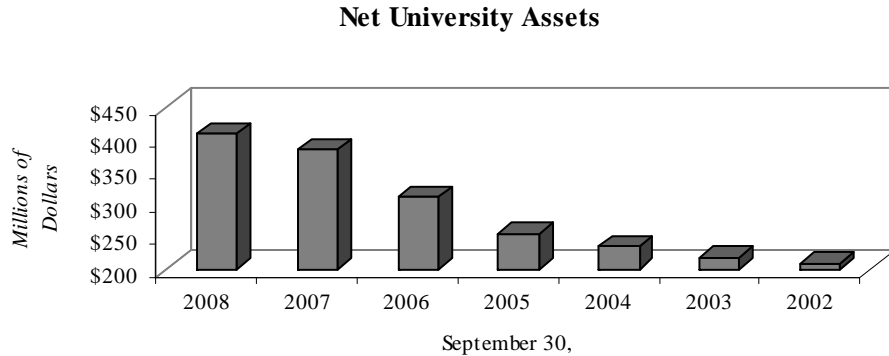
Unrestricted net assets represent those net assets not subject to externally imposed stipulations. Even though these funds are not legally restricted, the majority of the University's unrestricted net assets have been internally designated for various projects, all supporting the missions of the University. 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
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Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

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



Net assets invested in capital assets, net of related debt, increased approximately \$23,298,000 from September 30, 2007 to 2008. This increase was due primarily to increases in construction activity (net of bond funds used for construction) and other capital asset additions. Restricted expendable net assets decreased to \$23,071,000 at September 30, 2008 primarily due to the expenditure of funds restricted for use by the Mitchell Cancer Institute. Unrestricted net assets increased from \$168,045,000 to \$174,105,000 between 2007 and 2008.

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 noncapital 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 incurred 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 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
(A Component Unit of the State of Alabama)

Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

The Condensed Schedule of Revenues, Expenses, and Changes in Net Assets for the years ended September 30, 2008, 2007, and 2006 follows (in thousands):

**Condensed Schedule of Revenues, Expenses,
and Changes in Net Assets**

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Operating revenues:			
Tuition and fees	\$ 54,823	49,579	47,236
Net patient service revenue	201,603	205,337	201,373
Federal, state and private grants and contracts	77,245	74,874	78,217
Other	47,660	45,803	47,533
	<u>381,331</u>	<u>375,593</u>	<u>374,359</u>
Operating expenses:			
Salaries and benefits	370,749	333,688	317,626
Supplies and other services	123,782	111,297	109,653
Other	39,565	35,977	35,336
	<u>534,096</u>	<u>480,962</u>	<u>462,615</u>
Operating loss	<u>(152,765)</u>	<u>(105,369)</u>	<u>(88,256)</u>
Nonoperating revenues (expenses):			
State appropriations	139,737	120,388	101,203
Investment income (loss)	(4,257)	19,534	9,418
Other, net	12,332	14,855	23,250
Net nonoperating revenues	<u>147,812</u>	<u>154,777</u>	<u>133,871</u>
Income (loss) before capital contributions and additions to endowment	(4,953)	49,408	45,615
Capital contributions and additions to endowment	<u>28,764</u>	<u>23,750</u>	<u>9,787</u>
Increase in net assets	23,811	73,158	55,402
Beginning net assets	<u>384,516</u>	<u>311,358</u>	<u>255,956</u>
Ending net assets	<u>\$ 408,327</u>	<u>384,516</u>	<u>311,358</u>

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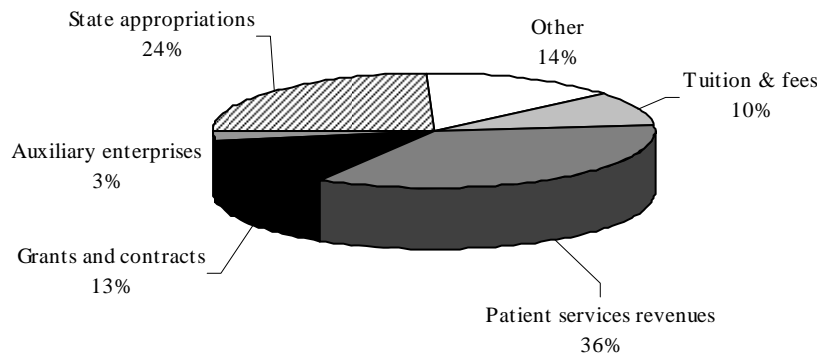
Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

In 2008, 2007, and 2006, approximately 36%, 38%, and 38%, respectively, of total 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 24% of total revenues in fiscal 2008. Also in 2008 tuition and fees charged to students and grants and contracts (federal, state and private) represented approximately 10% and 13% of total revenues, respectively.

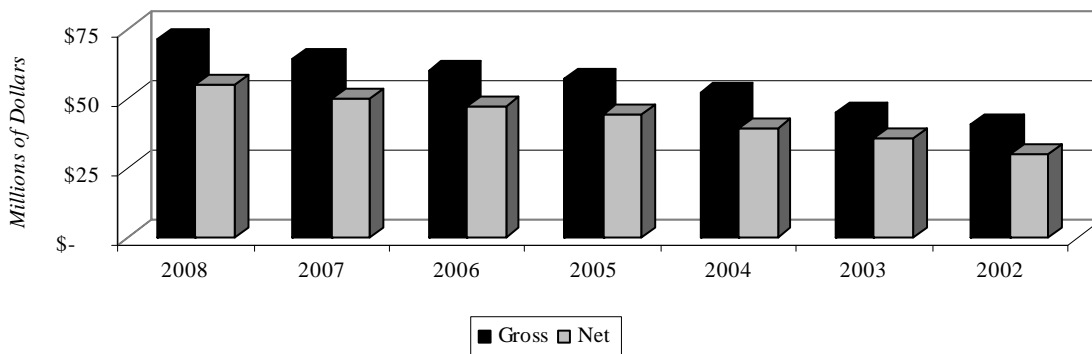
A summary of University revenues for the year ended September 30, 2008 is presented below:

Total Revenues



Tuition and fees have increased in each of the last six 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 students enrolled. Additionally, tuition and fees as a percent of total operating revenue continue to increase, from 9.5% of operating revenues in 2002 to 14% in 2008. Tuition and fees, gross and net of scholarship allowances, for the past seven fiscal years are as follows:

Tuition and Fee Revenues



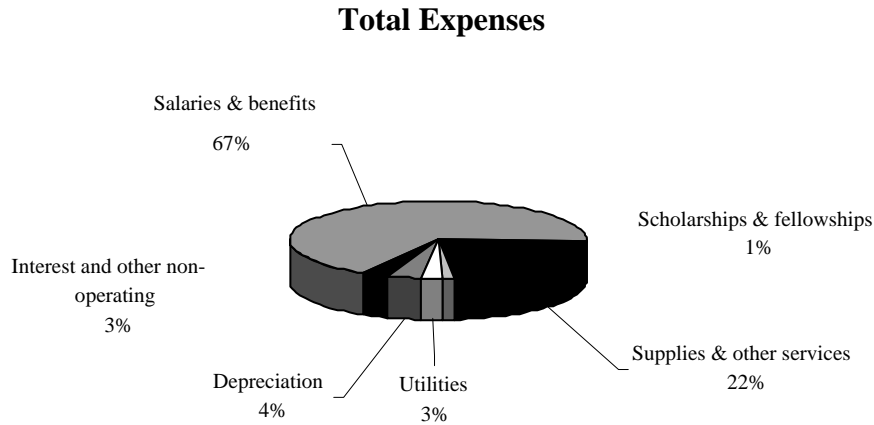
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Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

Further, additions to endowment increased from \$3,843,000 in 2007 to \$9,496,000 in 2008 primarily due to increased gifts as a result of the University's comprehensive fund raising campaign. As a result of significant fluctuations in financial markets conditions, net investment income (loss) increased from \$9,418,000 in 2006 to \$19,534,000 in 2007. In 2008, net investment income (loss) decreased by approximately \$23,791,000 to a net 2008 loss of \$4,257,000. Included in this amount are unrealized market losses of \$13,771,000 in 2008.

University expenses are presented using their natural expense classifications. A summary of University expenses for the year ended September 30, 2008 is presented below.



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. Functional expense information is presented in note 16 to the basic financial statements.

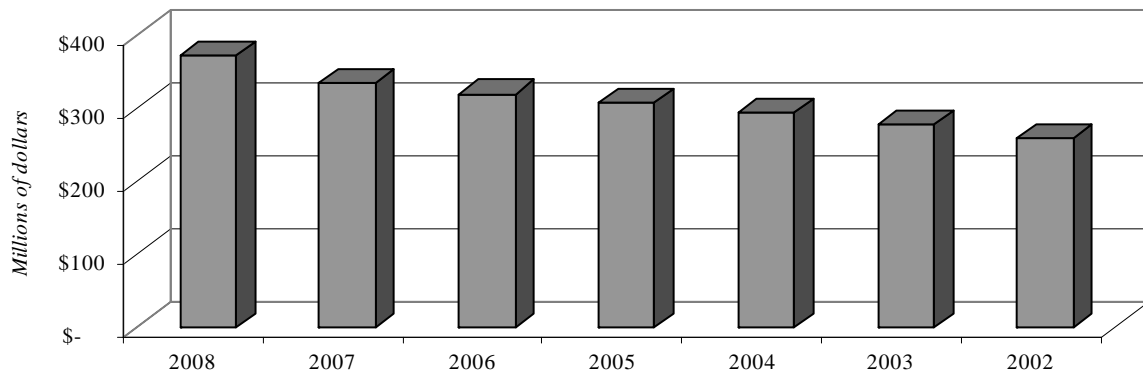
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Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

In 2008, 2007, and 2006, approximately 69% of the University's total operating expenses were salaries and benefits. Salaries and benefits have steadily increased over the last five years, resulting primarily from increases in salary rates to faculty and staff, as shown as follows:

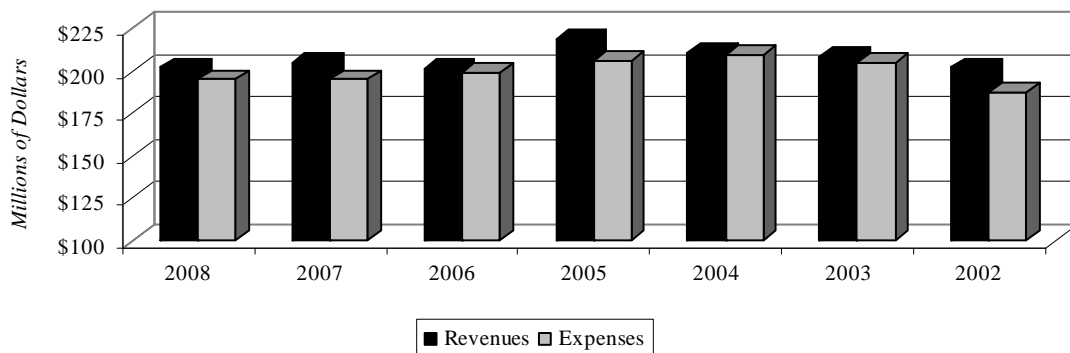
Total Salaries and Benefits Expense



For the years ended September 30, 2008, 2007, and 2006, the University reported an operating loss of approximately \$152,765,000, \$105,369,000, and \$88,256,000, respectively. Net operating losses are offset by state appropriations, which are reported 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 \$23,811,000, \$73,158,000, and \$55,402,000, for the years ended September 30, 2008, 2007, and 2006, respectively.

The Hospitals represent a significant portion of total University revenues and expenses and have remained relatively constant over the past three years. Operating hospital revenues and expenses for the last seven fiscal years are presented below:

Hospital Operating Revenues and Expenses



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Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

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 \$87,000,000 in 2008. Significant capital asset additions in fiscal 2008 include the Nursing and Allied Health Building, the Mitchell Cancer Institute and numerous ongoing construction projects at the University and Hospitals. Significant projects in fiscal 2006 and 2007 included Building II in the USA Technology and Research Park, JagTran (the campus shuttle system), Meisler Hall and ongoing projects. In 2007, Buildings II and III in the USA Technology and Research Park were sold to the USA Research and Technology Corporation. The proceeds from this sale were approximately \$11,986,000. At September 30, 2008, the University has outstanding commitments of approximately \$68,372,000 for various capital projects.

During 2007, the University sold the Health Services Building to the USA Research and Technology Corporation and also sold 100 lots in the Hillsdale area of campus to a third party. The University recognized a gain on the disposal of these assets of approximately \$3,739,000.

In September 2008, the University issued the University Facilities Revenue and Capital Improvement Bonds, Series 2008, with a face value of \$112,885,000. The net proceeds of these bonds, issued at a premium of approximately \$132,000, will be used to fund an expansion of the USA Children's and Women's Hospital as well as other construction and capital improvements at the University.

In January 2007, the University issued the University Tuition Revenue Refunding and Capital Improvement Bonds, Series 2006, with a face value of \$100,000,000. The proceeds of these bonds, issued at a premium of approximately \$6,780,000, were used to refund the University Tuition Revenue Refunding Bonds, Series 1996 and will be used to fund construction and other capital improvements at the University.

In order to realize debt service savings currently from future debt refunding, in January 2008, the University entered into a synthetic advance refunding of the outstanding Series 2004 and 2006 bonds. This transaction was effected through the sale of two swaptions by the University to a counterparty and resulted in an up-front payment to the University totaling \$9,328,000 in exchange for selling the counterparty the option to enter into an interest rate swap with respect to the Series 2004 and 2006 bonds. A portion of this payment is considered a borrowing and is included in the long-term debt of the University.

During the year ended September 30, 2008, the University's bond credit rating was upgraded by Moody's Investors Services from A2 to A1. This represents the first upgrade of the University's bond credit rating since 2004. The University also received a rating of A+ from Standard and Poor's Rating Services.

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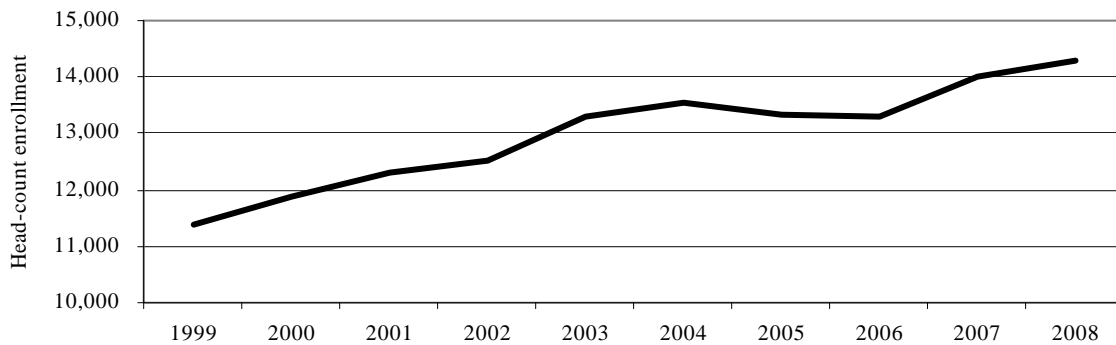
Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

Economic Outlook

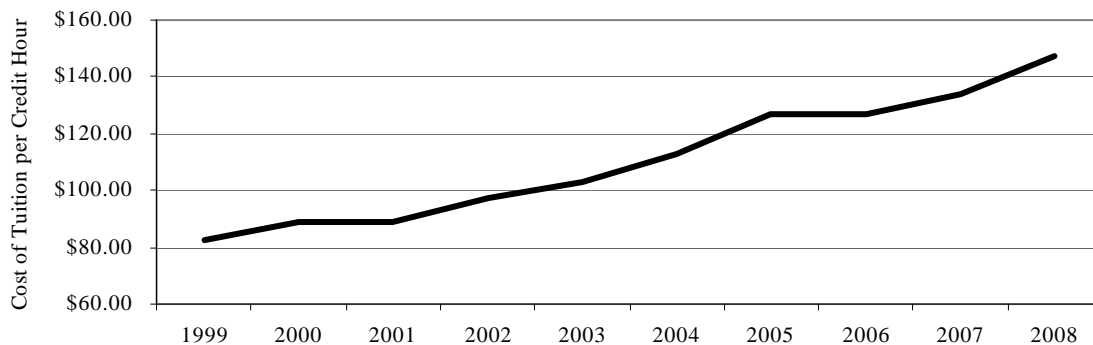
Student enrollment and tuition have both increased significantly over the past ten years. The University has experienced an increase in enrollment of approximately 25%, or 2,900 students, between 1999 and 2008, from 11,385 in 1999 to 14,279 for the 2008 fall semester. The enrollment trend for the University between 1999 and 2008 is as follows:

Enrollment - Ten Year Summary



In that same time period, in-state tuition per credit hour has increased by approximately 78%. Similar increases have been experienced in out-of-state tuition, College of Medicine tuition, fees and housing fees. The trend of in-state tuition per credit hour between 1999 and 2008 is as follows:

Tuition per Credit Hour



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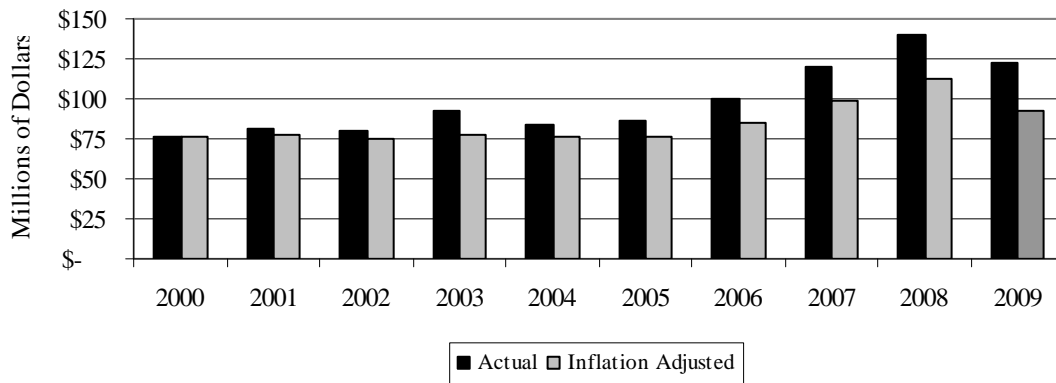
Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

While enrollment and tuition have both increased in recent years, state appropriations have historically been relatively flat. However, in the 2008, 2007 and 2006 fiscal years, the University experienced increases of 16.1%, 19.0% and 17.2%, respectively, or approximately \$19,349,000, \$19,185,000 and \$14,581,000, respectively, in state appropriations. These increases are unusually high and are not expected to continue. For the 2009 fiscal year, the University's appropriation decreased 12.8% or approximately \$17,882,000. Additionally, the University is aware that additional reductions in its 2009 appropriation are possible, as well as projected additional decreases in the 2010 fiscal year.

The ten year history of State Appropriations for the University is as follows:

State Appropriations - Ten Year History



In addition to state appropriations, the University is subject to declines in general economic conditions in the United States and, specifically, the State of Alabama. Recent declines in financial markets have had a significant impact on the value of the University's endowment. Further weakening of the economy could have a potential further negative impact on the University's enrollment, extramural funding, endowment performance and health care operations.

Other than the issues presented above, University administration is not aware of any other currently known facts, decisions, or conditions that are expected to have a significant effect on the University's financial position or results of operations during fiscal year 2009 beyond those unknown variables having a global effect on virtually all types of business operations.



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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, 2008 and 2007, 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 2008 and 2007 consolidated financial statements of the University of South Alabama Foundation, which represents 82%, 100% and (14)%, respectively, of the 2008 assets, net assets and revenues, gains and other support of the aggregate discretely presented component units and 84%, 99% and 37%, respectively, of the 2007 assets, net assets and revenues, gains and other support 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. The financial statements of the University of South Alabama Foundation, the University of South Alabama Health Services Foundation, the USA Research and Technology Corporation, and the Professional and General Liability Trust Funds were not audited in accordance with *Government Auditing Standards*. 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. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinions.

As discussed in note 1, the financial statements of the University are intended to present the financial position, changes in financial position and, where applicable, cash flows of only that portion of the basic financial statements and the aggregate discretely presented component units of the State of Alabama that is attributable to the transactions of the University. They do not purport to, and do not, present fairly the financial position of the State of Alabama as of September 30, 2008 and 2007, the changes in its financial position, or, where applicable, its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.



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, 2008 and 2007, and the respective changes in financial position and cash flows, where applicable, thereof for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 14, 2008, 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.

The management's discussion and analysis on pages 1 through 11 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. 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.

Our audits were performed 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, 2008 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*, and is not a required part of the basic financial statements. The Schedule of Expenditures of Federal Awards has been subjected to the auditing procedures applied in the audit of the 2008 basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the 2008 basic financial statements taken as a whole.

KPMG LLP

November 14, 2008

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

Statements of Net Assets
September 30, 2008 and 2007
(In thousands)

	2008	2007
Assets:		
Current assets:		
Cash and cash equivalents	\$ 34,914	51,864
Investments	187,947	153,292
Net patient accounts receivable, (net of allowance for doubtful accounts of \$45,650 and \$42,447)	26,018	30,950
Accounts receivable, affiliates	15,329	11,521
Accounts receivable, other	14,485	17,577
Notes receivable, net	837	787
Prepaid expenses, inventories, and other	7,900	5,992
Total current assets	287,430	271,983
Noncurrent assets:		
Restricted cash and cash equivalents	95,893	5,820
Restricted investments	103,889	123,050
Investments	1,105	1,621
Accounts receivable	7,237	7,235
Notes receivable, net	4,887	5,623
Other noncurrent assets	8,396	5,465
Capital assets, net	353,829	286,890
Total noncurrent assets	575,236	435,704
Total assets	862,666	707,687
Liabilities:		
Current liabilities:		
Accounts payable and accrued liabilities	58,588	49,606
Deferred revenue	26,228	24,744
Deposits	990	668
Current portion of long-term debt	4,967	5,371
Total current liabilities	90,773	80,389
Noncurrent liabilities:		
Long-term debt, less current portion	311,359	194,428
Other long-term liabilities	52,207	48,354
Total noncurrent liabilities	363,566	242,782
Total liabilities	454,339	323,171
Net assets:		
Invested in capital assets, net of related debt	186,986	163,688
Restricted, nonexpendable:		
Scholarships	10,741	7,172
Other	13,424	9,656
Restricted, expendable:		
Scholarships	4,698	4,541
Other	18,373	31,414
Unrestricted	174,105	168,045
Total net assets	\$ 408,327	384,516

See accompanying notes to basic financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statements of Financial Position

June 30, 2008 and 2007

(In thousands)

Assets	2008	2007
Cash and cash equivalents	\$ 1,337	1,713
Investments:		
Securities, at fair value	120,133	142,709
Timber and mineral properties	154,462	150,364
Real estate	9,792	18,794
Other	5,500	5,500
Other assets	452	488
Total assets	\$ 291,676	319,568
Liabilities and Net Assets		
Liabilities:		
Accounts payable	\$ 82	20
Other liabilities	646	779
Total liabilities	728	799
Net assets:		
Unrestricted	87,273	88,012
Temporarily restricted	34,739	59,707
Permanently restricted	168,936	171,050
Total net assets	290,948	318,769
Total liabilities and net assets	\$ 291,676	319,568

See accompanying notes to basic financial statements.

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

Statements of Financial Position

September 30, 2008 and 2007

(In thousands)

Assets	2008	2007
Current assets:		
Cash and cash equivalents	\$ 846	690
Patient accounts receivable (net of allowance for uncollectible accounts of approximately \$5,281 and \$5,745)	10,747	10,949
Other current assets	1,269	1,621
Total current assets	<u>12,862</u>	<u>13,260</u>
Interest in assets of University of South Alabama Professional Liability Trust Fund	20,928	19,236
Property and equipment, net	2,604	2,769
Total assets	<u>\$ 36,394</u>	<u>35,265</u>
Liabilities and Net Assets (Deficit)		
Current liabilities:		
Accounts payable	\$ 1,978	2,035
Accrued payroll	—	30
Current portion of notes payable	570	935
Due to affiliates	15,069	11,137
Total current liabilities	<u>17,617</u>	<u>14,137</u>
Notes payable, less current portion	—	570
Estimated professional liability costs	20,928	19,236
Total liabilities	<u>38,545</u>	<u>33,943</u>
Unrestricted net assets (deficit)	<u>(2,151)</u>	<u>1,322</u>
Total liabilities and net assets (deficit)	<u>\$ 36,394</u>	<u>35,265</u>

See accompanying notes to basic financial statements.

USA RESEARCH AND TECHNOLOGY CORPORATION

(Discretely Presented Component Unit)

Statements of Net Assets

September 30, 2008 and 2007

(In thousands)

	<u>2008</u>	<u>2007</u>
Assets:		
Current assets:		
Cash and cash equivalents	\$ 1,505	649
Investments	3,265	988
Rent receivable	147	—
Tenant expense reimbursements	14	120
Total current assets	<u>4,931</u>	<u>1,757</u>
Noncurrent assets:		
Intangible assets, net	245	122
Capital assets, net	24,052	22,547
Total noncurrent assets	<u>24,297</u>	<u>22,669</u>
Total assets	<u>29,228</u>	<u>24,426</u>
Liabilities:		
Current liabilities:		
Deposits, other current liabilities, and accrued expenses	556	358
Payable to University of South Alabama	11	—
Deferred rent income	137	23
Current portion of note payable	858	465
Total current liabilities	<u>1,562</u>	<u>846</u>
Noncurrent liabilities:		
Notes payable, excluding current portion	26,173	22,492
Total noncurrent liabilities	<u>26,173</u>	<u>22,492</u>
Total liabilities	<u>27,735</u>	<u>23,338</u>
Net assets (deficit):		
Invested in capital assets, net of related debt	(259)	(459)
Unrestricted	1,752	1,547
Total net assets	<u>\$ 1,493</u>	<u>1,088</u>

See accompanying notes to basic 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, 2008 and 2007

(In thousands)

	2008	2007
Operating revenues:		
Tuition and fees (net of scholarship allowances of \$16,483 and \$14,401)	\$ 54,823	49,579
Net patient service revenue	201,603	205,337
Federal grants and contracts	22,378	23,088
State grants and contracts	8,238	6,822
Private grants and contracts	46,629	44,964
Auxiliary enterprises (net of scholarship allowances of \$510 and \$432)	16,866	16,633
Other operating revenues	30,794	29,170
Total operating revenues	381,331	375,593
Operating expenses:		
Salaries and benefits	370,749	333,688
Supplies and other services	123,782	111,297
Scholarships and fellowships	4,997	4,295
Utilities	14,400	12,623
Depreciation and amortization	20,168	19,059
Total operating expenses	534,096	480,962
Operating loss	(152,765)	(105,369)
Nonoperating revenues (expenses):		
State appropriations	139,737	120,388
Investment income (loss)	(4,257)	19,534
Interest expense	(8,089)	(7,654)
Other nonoperating revenues	27,018	27,401
Other nonoperating expenses	(6,597)	(4,892)
Net nonoperating revenues	147,812	154,777
Income (loss) before capital contributions and additions to endowment	(4,953)	49,408
Capital contributions and grants	19,268	19,907
Additions to endowment	9,496	3,843
Increase in net assets	23,811	73,158
Net assets:		
Beginning of year	384,516	311,358
End of year	\$ 408,327	384,516

See accompanying notes to basic financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statement of Activities and Changes in Net Assets

Year ended June 30, 2008

(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	\$ 3,011	(18,258)	(2,528)	(17,775)
Rents, royalties and timber sales	4,536	—	70	4,606
Interest and dividends	1,663	1,586	7	3,256
Gifts	—	7	170	177
Other income	5	24	—	29
Required match of donor contributions	(167)	—	167	—
Interfund interest	(513)	513	—	—
Net assets released from program restrictions	8,840	(8,840)	—	—
Total revenues, gains, and other support	<u>17,375</u>	<u>(24,968)</u>	<u>(2,114)</u>	<u>(9,707)</u>
Expenditures:				
Program services:				
Faculty support	2,521	—	—	2,521
Scholarships	1,016	—	—	1,016
Other	6,262	—	—	6,262
Total program service expenditures	<u>9,799</u>	<u>—</u>	<u>—</u>	<u>9,799</u>
Management and general	2,007	—	—	2,007
Other investment expense	2,900	—	—	2,900
Depreciation and depletion expense	3,408	—	—	3,408
Total expenditures	<u>18,114</u>	<u>—</u>	<u>—</u>	<u>18,114</u>
Decrease in net assets	(739)	(24,968)	(2,114)	(27,821)
Net assets – beginning of year	<u>88,012</u>	<u>59,707</u>	<u>171,050</u>	<u>318,769</u>
Net assets – end of year	<u>\$ 87,273</u>	<u>34,739</u>	<u>168,936</u>	<u>290,948</u>

See accompanying notes to basic financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statement of Activities and Changes in Net Assets

Year ended June 30, 2007

(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	\$ 16,505	13,642	274	30,421
Rents, royalties and timber sales	5,997	—	74	6,071
Interest and dividends	965	2,263	12	3,240
Gifts	—	—	6,271	6,271
Other income	32	—	—	32
Required match of donor contributions	(1)	—	1	—
Interfund interest	(643)	643	—	—
Net assets released from program restrictions	5,720	(5,720)	—	—
Total revenues, gains, and other support	<u>28,575</u>	<u>10,828</u>	<u>6,632</u>	<u>46,035</u>
Expenditures:				
Program services:				
Faculty support	2,448	—	—	2,448
Scholarships	1,031	—	—	1,031
Other	3,532	—	—	3,532
Total program service expenditures	<u>7,011</u>	<u>—</u>	<u>—</u>	<u>7,011</u>
Management and general	2,278	—	—	2,278
Other investment expense	1,693	—	—	1,693
Depreciation and depletion expense	6,786	—	—	6,786
Total expenditures	<u>17,768</u>	<u>—</u>	<u>—</u>	<u>17,768</u>
Increase in net assets	10,807	10,828	6,632	28,267
Net assets – beginning of year	<u>77,205</u>	<u>48,879</u>	<u>164,418</u>	<u>290,502</u>
Net assets – end of year	<u>\$ 88,012</u>	<u>59,707</u>	<u>171,050</u>	<u>318,769</u>

See accompanying notes to basic financial statements.

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

Statements of Operations and Changes in Net Assets

Years ended September 30, 2008 and 2007

(In thousands)

	2008	2007
Unrestricted revenues, gains and other support:		
Net patient service revenue	\$ 67,484	66,917
Other revenue	7,857	8,281
Total unrestricted revenues, gains and other support	75,341	75,198
Expenses:		
Salaries and benefits	46,212	43,479
General and administrative	17,748	15,945
Provision for uncollectible accounts	13,459	12,631
Depreciation and amortization	993	945
Interest	65	138
Total expenses	78,477	73,138
Operating income (loss)	(3,136)	2,060
Nonoperating gains	180	215
Revenues over (under) expenses	(2,956)	2,275
Contributions restricted for debt service, received and expended within the same year	1,000	1,000
Transfer of capital to University of South Alabama College of Medicine	(1,517)	(3,041)
Change in unrestricted net assets	(3,473)	234
Unrestricted net assets at beginning of year	1,322	1,088
Unrestricted net assets (deficit) at end of year	\$ (2,151)	1,322

See accompanying notes to basic financial statements.

USA RESEARCH AND TECHNOLOGY CORPORATION
(Discretely Presented Component Unit)

Statement of Revenues, Expenses, and Changes in Net Assets

Year ended September 30, 2008

(In thousands)

	2008	2007
Operating revenues:		
Rental income	\$ 2,879	1,955
Tenant reimbursements	29	161
Total operating revenues	2,908	2,116
Operating expenses:		
Building management and operating expenses	532	428
Depreciation and amortization	681	646
Legal and administrative fees	32	17
Insurance	57	68
Total operating expenses	1,302	1,159
Operating income	1,606	957
Nonoperating revenues (expenses):		
Investment income	82	37
Interest expense	(1,426)	(765)
Donations	140	—
Other	3	—
Net nonoperating expenses	(1,201)	(728)
Increase in net assets	405	229
Net assets:		
Beginning of year	1,088	859
End of year	\$ 1,493	1,088

See accompanying notes to basic financial statements.

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

Statements of Cash Flows

Years ended September 30, 2008 and 2007

(In thousands)

	<u>2008</u>	<u>2007</u>
Cash flows from operating activities:		
Receipts related to tuition and fees	\$ 57,061	51,535
Receipts from and on behalf of patients and third-party payers	206,743	201,628
Receipts from grants and contracts	79,517	72,694
Receipts related to auxiliary enterprises	16,823	14,860
Payments to suppliers and vendors	(141,907)	(107,874)
Payments to employees and related benefits	(366,379)	(332,995)
Payments for scholarships and fellowships	(5,451)	(4,251)
Other operating receipts	31,856	27,476
Net cash used in operating activities	<u>(121,737)</u>	<u>(76,927)</u>
Cash flows from noncapital financing activities:		
State appropriations	139,737	120,388
Endowment gifts	9,361	3,843
Agency funds received	625	943
Agency funds disbursed	(280)	(871)
Stafford and PLUS loans received	76,739	62,840
Stafford and PLUS loans disbursed	(76,857)	(63,070)
New loans issued to students	(113)	(823)
Student loan repayments	299	634
Other nonoperating revenues	26,476	22,203
Other nonoperating expenses	(5,173)	(4,776)
Net cash provided by noncapital financing activities	<u>170,814</u>	<u>141,311</u>
Cash flows from capital and related financing activities:		
Capital contributions and grants	19,268	19,907
Purchases of capital assets	(89,417)	(67,400)
Proceeds from sale of capital assets	68	6,591
Proceeds from issuance of capital debt	120,085	106,780
Principal payments on capital debt	(5,281)	(29,625)
Interest payments on capital debt	(7,860)	(5,441)
Net cash provided by capital and related financing activities	<u>36,863</u>	<u>30,812</u>
Cash flows from investing activities:		
Interest and dividends on investments	11,590	17,924
Purchases of investments	(392,507)	(337,919)
Proceeds from sales of investments	368,100	244,323
Net cash used in investing activities	<u>(12,817)</u>	<u>(75,672)</u>
Net increase in cash and cash equivalents	73,123	19,524
Cash and cash equivalents (unrestricted and restricted):		
Beginning of year	57,684	38,160
End of year	<u>\$ 130,807</u>	<u>57,684</u>

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

Statements of Cash Flows

Years ended September 30, 2008 and 2007

(In thousands)

	2008	2007
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	\$ (152,765)	(105,369)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation expense	20,168	19,059
Changes in assets and liabilities, net:		
Student receivables	(1,042)	96
Net patient accounts receivable	3,628	(2,917)
Grants and contracts receivables	1,742	(268)
Student loan program receivables	444	(190)
Other receivables	8,345	2,403
Prepaid expenses, inventories, and other	1,035	(1,529)
Accounts payable and accrued liabilities	(8,445)	9,024
Deferred revenue	5,153	2,764
Net cash used in operating activities	\$ (121,737)	(76,927)
Noncash investing, noncapital financing, and capital and related financing transactions:		
Increase (decrease) in fair value of investments recognized as a component of investment income	\$ (13,771)	2,404
Additional maturity on capital appreciation bonds payable recorded as interest expense	1,813	1,468
Gifts of capital and other assets	60	—
Pledges of operating and capital gifts	412	2,414
Capitalization of construction period interest	1,537	848
Increase (decrease) in accounts payable related to capital assets	(2,226)	522

See accompanying notes to basic financial statements.

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

Notes to Basic Financial Statements

September 30, 2008 and 2007

(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 statements of the University are intended to present the financial position, changes in financial position and, where applicable, cash flows of only that portion of the basic financial statements and the aggregate discretely presented component units of the State of Alabama that is attributable to the transactions of the University.

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 Component 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.

The University has 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 as of September 30, 2008 and 2007, the University reports the University of South Alabama Foundation (USA Foundation), the University of South Alabama Health Services Foundation (USAHSF), and the USA Research and Technology Corporation (the Corporation) as discretely presented component units.

The University is also affiliated with the South Alabama Medical Science Foundation (SAMSF). This entity is not considered a component unit of the University under the provisions of GASB Statement Nos. 14 and 39 because the University does not consider SAMSF significant enough to warrant inclusion in the University's reporting entity (see note 14 for further discussion of this entity).

(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

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

Notes to Basic Financial Statements

September 30, 2008 and 2007

governed by the University Board of Trustees through the University president. As such, PLTF and GLTF are reported as blended component units.

(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, 2008 and 2007 were \$9,627,000 and \$7,011,000, 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 since the USA Foundation follows FASB rather than GASB pronouncements. 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, 2008 and 2007 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, Dean's clinical assessment and other support services. Total amounts received and accrued for such expenses were approximately \$40,745,000 and \$40,059,000 for the years ended September 30, 2008 and 2007, 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 for the USAHSF for the years ended September 30, 2008 and 2007 are discretely presented following the statements of net assets and statements of revenues, expenses, and changes in net assets of the University.

(e) *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

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

Notes to Basic Financial Statements

September 30, 2008 and 2007

opportunities to the University's students and faculty. Because of the significance of the relationship between the University and the Corporation, the Corporation is considered a component unit of the University. The Corporation presents its financial statements in accordance with GASB.

(f) *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.

The University prepares its basic financial statements in accordance with U. S. generally accepted accounting principles, 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.

(g) *Use of Estimates*

The preparation of financial statements in conformity with U. S. generally accepted accounting principles 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.

(h) *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 have maturities of less than three months and include repurchase agreements and money market accounts.

(i) *Investments and Investment Income*

Investments are recorded at fair value. The fair value of alternative investments (limited partnerships, private equity securities, etc.) do not have readily ascertainable market values and the University values these investments in accordance with valuations provided by the general partners or fund managers of the underlying partnership or companies. Because these investments are not marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for the investment existed. 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 (loss.)

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

Notes to Basic Financial Statements

September 30, 2008 and 2007

The liquidity crisis that originally was linked principally to the sub-prime lending markets has spread to other corners of the credit markets in the U.S. and internationally. It is not possible at this time to predict the full impact or duration of the existing illiquid credit market conditions. The unstable market conditions and the resulting uncertainties contribute to additional risks associated with certain significant investment valuation estimates. Management continues to monitor the composition of its portfolio to assess the potential impact of these market conditions on the valuation of its investments.

(j) Accounts Receivable

Accounts receivable primarily result from net patient service revenue. Accounts receivable from affiliates primarily represent amounts due from USAHSF for salaries, and certain administrative and other support services. 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.

(k) 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.

(l) Capital Assets

Capital assets are recorded at cost, if purchased, or at fair value at date of donation. Depreciation is provided over the estimated 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 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, infrastructure and certain building components	40 to 100 years
Fixed equipment	10 to 20 years
Land improvements	8 to 20 years
Library materials	10 years
Other equipment	4 to 15 years

Certain buildings are componentized for depreciation purposes.

Interest costs for certain assets constructed are capitalized as a component of the cost of acquiring those assets.

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

Notes to Basic Financial Statements

September 30, 2008 and 2007

The University evaluates impairment in accordance with GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. For the years ended September 30, 2008 and 2007, no impairments were recorded.

(m) Deferred Revenue

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

Operating lease rental payments related to the University's lease of USA Knollwood Hospital to the Infirmary Health System, Inc. (see note 11) are deferred and recognized as revenue over the term of the lease using the straight-line method.

The time value component of the payment to the University resulting from the sale of two swaptions by the University with respect to the outstanding Series 2004 and 2006 bonds is deferred and recognized as investment income over the term of the swaption (see note 5).

(n) 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.

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.

UNIVERSITY OF SOUTH ALABAMA
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Notes to Basic Financial Statements

September 30, 2008 and 2007

(o) ***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.

(p) ***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.

(q) ***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 and investment income.

(r) ***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.

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(s) ***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.

(t) ***Net Patient Service Revenue***

Net patient service revenue is reported at estimated net realizable amounts due from patients, third-party payers and others for healthcare services rendered, including estimated retroactive revenue 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.

(u) ***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.

(v) ***Compensated Absences***

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

(w) ***Reclassifications***

Certain amounts in the 2007 basic financial statements have been reclassified in order to conform to the 2008 classification.

(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.

In addition, the University's discretely presented component units are tax-exempt entities under Section 501(a) of the Internal Revenue Code as organizations described in Section 501(c)(3). Consistent with that designation, no provision for income taxes has been made in the accompanying discretely presented financial statements.

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(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, 2008, the net public deposits subject to collateral requirements for all institutions participating in the pool totaled approximately \$7,833,381,000. The University had cash and cash equivalents totaling \$130,807,000 and \$57,684,000 at September 30, 2008 and 2007, respectively.

(4) Investments

(a) University of South Alabama

The investments of the University are invested pursuant to the University of South Alabama "Nonendowment Cash Pool Investment Policies," the "Endowment Fund Investment Policy," and the "Derivatives Policy" (collectively referred to as the University Investment Policies) as adopted by the Board of Trustees. The purpose of the nonendowment 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, investments 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.

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Investments of the University, by type, at fair value, are as follows at September 30, 2008 and 2007 (in thousands).

	2008	2007
U.S. Treasury notes	\$ 14,977	14,402
U.S. federal agency notes	188,810	103,572
Commercial paper	14,231	100,554
Pooled equity mutual funds	44,229	35,938
Pooled debt mutual funds	15,328	12,710
Managed income alternative investments (limited partnerships, private equity securities, and other)	12,858	10,532
Other	2,508	255
	\$ 292,941	277,963

At September 30, 2008 and 2007, \$3,849,000 and \$5,182,000, 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 and Concentration of 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.

Additionally, 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.

The University’s exposure to credit risk and concentration of credit risk at September 30, 2008 is as follows:

	Credit rating	Percentage of total investments
Federal Home Loan Mortgage Corporation	AAA	27.3%
Federal Home Loan Bank Corporation	AAA	15.0
G. E. Capital Corporation	Aaa	3.4
Federal National Mortgage Association	AAA	1.5
Common – Bond Fund	AA	3.6
Federal Farm Credit Banks Funding Corporation	AAA	1.0
Government National Mortgage Association	AAA	0.1

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The University's exposure to credit risk and concentration of credit risk at September 30, 2007 is as follows:

	<u>Credit rating</u>	<u>Percentage of total investments</u>
Federal Home Loan Mortgage Corporation	AAA	16.4%
Federal Home Loan Bank Corporation	AAA	14.2
G. E. Capital Corporation	A-1+	10.7
UBS Finance	A-1+	9.0
AIG Funding Corporation	A-1+	7.7
Federal National Mortgage Association	AAA	6.2
American Express Credit Corporation	A-1	5.2
Common – Bond Fund	AA	4.6
Citigroup Funding, Inc.	A-1+	3.5
Federal Farm Credit Banks Funding Corporation	AAA	0.4
Government National Mortgage Association	AAA	0.1

Interest Rate Risk

At September 30, 2008, the maturity dates of the University's debt investments were as follows (in thousands):

	<u>Fair value</u>	<u>Years to maturity</u>			
		<u>Less than 1</u>	<u>1 – 5</u>	<u>6 – 10</u>	<u>More than 10</u>
U.S. Treasury notes	\$ 14,977	4,810	10,167	—	—
U.S. federal agency notes	188,810	169,011	18,012	324	1,463
Commercial paper	14,231	14,231	—	—	—
Pooled debt mutual funds	15,328	—	15,328	—	—
	<u>\$ 233,346</u>	<u>188,052</u>	<u>43,507</u>	<u>324</u>	<u>1,463</u>

At September 30, 2007, the maturity dates of the University's debt investments were as follows (in thousands):

	<u>Fair value</u>	<u>Years to maturity</u>			
		<u>Less than 1</u>	<u>1 – 5</u>	<u>6 – 10</u>	<u>More than 10</u>
U.S. Treasury notes	\$ 14,402	3,240	11,162	—	—
U.S. federal agency notes	103,572	86,232	16,187	757	396
Commercial paper	100,554	100,554	—	—	—
Pooled debt mutual funds	12,710	—	—	12,710	—
	<u>\$ 231,238</u>	<u>190,026</u>	<u>27,349</u>	<u>13,467</u>	<u>396</u>

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Because the debt mutual funds had a weighted average maturity of 4.8 and 6.5 years, the investments were presented in the 1-5 year and the 6-10 year maturity category at September 30, 2008 and 2007, respectively.

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

Mortgage-Backed Securities

The University, from time to time, 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. There are no CMOs in the University's investment portfolio at September 30, 2008 or 2007.

At September 30, 2008, restricted investments consist of \$50,079,000 related to unspent bond proceeds and \$53,810,000 related to investments included in the PLTF and GLTF to pay insurance liability claims. At September 30, 2007, restricted investments consist of \$73,181,000 related to unspent bond proceeds and \$49,869,000 related to investments included in the PLTF and GLTF to pay insurance liability claims.

(b) University of South Alabama Foundation

Investments in securities consist primarily of marketable equity securities totaling \$120,133,000 and \$142,709,000, at June 30, 2008 and 2007, respectively.

Investment income (loss) was comprised of the following for the years ended June 30, 2008 and 2007 (in thousands):

	2008	2007
Unrealized gains (losses)	\$ (19,142)	28,451
Realized gains	1,367	1,970
Timber sales	3,813	5,373
Interest and dividends	3,256	3,240
Rents	520	549
Royalties	273	149
	\$ (9,913)	39,732

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Investment related expenses in the amount of \$350,000 and \$339,000, respectively, are included in the USA Foundation's management and general expenses in the accompanying 2008 and 2007 consolidated statements of activities and changes in net assets.

Real estate at June 30, 2008 and 2007 consisted of the following property held (in thousands):

	2008	2007
Land and land improvements – held for investment	\$ 8,658	16,525
Building and building improvements – held for investment, net of depreciation	1,134	2,269
	\$ 9,792	18,794

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.

In the fiscal year ended June 30, 2008, the Foundation sold three parcels of real estate totaling approximately 53 acres, including the former Wright Campus consisting of approximately 32 acres, for \$9,367,000. The Foundation recognized a gain on the sale of real estate in the amount of \$396,000.

Investments at June 30, 2008, include an equity interest in a timberland management company. The company's primary assets consist of timberland. The Foundation's proportionate share of the fair value of the company is based upon the valuation of the trustee responsible for the management of the company and the timber valuation.

(5) Derivative Transactions

In January 2008, the University entered into a synthetic advance refunding of the outstanding Series 2004 and 2006 bonds with a counterparty. This transaction was effected through the sale of two swaptions by the University to the counterparty. The transactions resulted in an up-front payment to the University totaling \$9,328,000, which was recorded as a liability, in exchange for selling the counterparty the option to enter into an interest rate swap with respect to the Series 2004 and 2006 bonds in 2014 and 2016, respectively.

Objective of the Derivative Transaction

The objective of this transaction is to realize debt service savings currently from future debt refunding and create an economic benefit to the University.

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Terms

A summary of the transactions is as follows:

<u>Issue</u>	<u>Date of issue</u>	<u>Option expiration date</u>	<u>Effective date of swap</u>	<u>Termination date</u>	<u>Payment amount</u>
Series 2004 bonds	2-Jan-08	16-Dec-13	15-Mar-14	15-Mar-24	\$ 1,988,000
Series 2006 bonds	2-Jan-08	1-Sep-16	1-Dec-16	1-Dec-36	7,340,000

If the counterparty exercises its options in 2014 and 2016, the University would, at the counterparty's option, be forced into an underlying swap. If the option is exercised, the University would begin to make payments on the notional amount, currently \$46,245,000 and \$100,000,000 for the 2004 bonds and 2006 bonds, respectively, of the underlying swap contract. Simultaneously, the University would call outstanding 2004 and 2006 bonds and issue variable rate demand notes (VRDNs) in their place. Under the swap contract, the University would pay a fixed rate of 4.9753% on the 2004 bonds and 5.0% on the 2006 bonds to the counterparty and would receive payments based on 68% of the one-month LIBOR index. Alternatively, although it is not anticipated that this option would be to the University advantage, the University could, at its option, cash settle the swap and retain its right to refund the 2004 and 2006 bonds.

If the interest rate environment is such that the counterparty chooses to not exercise its option, the swaption would be canceled and the University would have no further obligation under this agreement.

Financial Statement Presentation

A swaption is considered a hybrid instrument and consists of two components, a time value, and an intrinsic value. The intrinsic value of the swaption represents the value of the counterparty's option if it were exercised immediately. The time value of the swaption is the difference between the total value and the intrinsic value and represents the probability weighted, discounted values of a range of future possible outcomes. The time and intrinsic values at the date of execution of this transaction are as follows:

	<u>2004 Bonds</u>	<u>2006 Bonds</u>
Time value	\$ 520,000	1,741,000
Intrinsic value	1,468,000	5,599,000
	<u>\$ 1,988,000</u>	<u>7,340,000</u>

The time value of the payment to the University is considered deferred investment income and is being amortized to investment income through the expiration date of the option. For the year ended September 30, 2008, \$237,000 was amortized and that amortization is included as investment income in the statement of revenues, expenses, and changes in net assets.

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The intrinsic value of the payment to the University is considered a borrowing, and as such is included in long-term debt on the University's 2008 statement of net assets. Interest is being accrued on, and added to, the borrowing through the expiration date of the option. For the year ended September 30, 2008, \$269,000 was accrued and is included in interest expense in the 2008 statement of revenues, expenses, and changes in net assets.

Fair Value

At September 30, 2008, the derivative transactions had a fair value of \$(12,290,000).

Risks Associated with this Transaction

Certain risks are inherent to derivative transactions.

Interest rate risk. Interest rate risk, as a result of rising short-term interest rates causing higher interest rate payments, is effectively hedged by the University's fixed rate bonds. If the counterparty exercises its options, the underlying swaps are expected to effectively hedge the potentially higher payments on VRDNs as well. The University is also subject to interest rate risk, as a result of changes in long-term interest rates, which may cause the value of fixed rate bonds or interest rate derivatives to change. If long-term interest rates fall subsequent to the execution of this transaction, the value of the swaptions will change, with negative consequences for the University.

Market access risk. This transaction assumes that VRDNs will be issued as a replacement of the 2004 and 2006 bonds. If the University is unable to issue variable rate bonds after the counterparty exercises its right under the swaptions, the University would still be required to begin making periodic payments on the swaps, even though there are no related bonds. Alternatively, the University could choose to liquidate the swaps, which may create a substantial cash outlay.

Basis risk. If the counterparty exercises its option, there is a risk that the floating payments received under the swaps will not fully offset the variable rate payments due on the assumed VRDNs.

Credit risk. Although the underlying swap exposes the University to credit risk should the swap be executed, the swaption itself does not expose the University to credit risk. If the option is exercised on one or both issues, the University would begin to make payments on the appropriate notional amount of the underlying swap contract. In that situation, if the fair value of the swap is positive, the University would be exposed to credit risk on the swap in the amount of its fair value. As of September 30, 2008, the swap counterparty was rated Aa3 by Moody's Investors Services and AA- by Fitch Ratings.

Termination risk. The University may be required to terminate the swaptions or swaps under certain circumstances, such as credit downgrades or other events specified in the contracts. In the event that a position needs to be terminated, the University may owe a substantial amount of money to terminate the contracts. At September 30, 2008, no events of termination have occurred.

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(6) Capital Assets

(a) University of South Alabama

A summary of the University's capital asset activity for the year ended September 30, 2008 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	\$ 29,271	55	—	(39)	29,287
Construction-in-progress	64,828	65,291	(11,868)	—	118,251
	<u>94,099</u>	<u>65,346</u>	<u>(11,868)</u>	<u>(39)</u>	<u>147,538</u>
Capital assets being depreciated:					
Land improvements	21,888	—	104	—	21,992
Buildings, fixed equipment, and infrastructure	298,751	1,431	10,786	—	310,968
Other equipment	99,147	17,762	978	(2,095)	115,792
Library materials	40,519	2,652	—	—	43,171
	<u>460,305</u>	<u>21,845</u>	<u>11,868</u>	<u>(2,095)</u>	<u>491,923</u>
Less accumulated depreciation for:					
Land improvements	(10,747)	(1,076)	—	—	(11,823)
Buildings, fixed equipment, and infrastructure	(159,404)	(8,124)	—	—	(167,528)
Other equipment	(68,165)	(8,345)	—	1,943	(74,567)
Library materials	(29,198)	(2,516)	—	—	(31,714)
	<u>(267,514)</u>	<u>(20,061)</u>	<u>—</u>	<u>1,943</u>	<u>(285,632)</u>
Capital assets being depreciated, net	<u>192,791</u>	<u>1,784</u>	<u>11,868</u>	<u>(152)</u>	<u>206,291</u>
Capital assets, net	<u>\$ 286,890</u>	<u>67,130</u>	<u>—</u>	<u>(191)</u>	<u>353,829</u>

At September 30, 2008, the University had commitments of approximately \$68,372,000 related to various construction projects.

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A summary of the University's capital asset activity for the year ended September 30, 2007 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	\$ 28,490	994	—	(213)	29,271
Construction-in-progress	45,671	47,118	(27,961)	—	64,828
	<u>74,161</u>	<u>48,112</u>	<u>(27,961)</u>	<u>(213)</u>	<u>94,099</u>
Capital assets being depreciated:					
Land improvements	17,470	45	4,373	—	21,888
Buildings, fixed equipment, and infrastructure	287,227	3,051	22,916	(14,443)	298,751
Other equipment	88,341	14,234	672	(4,100)	99,147
Library materials	38,039	2,480	—	—	40,519
	<u>431,077</u>	<u>19,810</u>	<u>27,961</u>	<u>(18,543)</u>	<u>460,305</u>
Less accumulated depreciation for:					
Land improvements	(9,910)	(837)	—	—	(10,747)
Buildings, fixed equipment, and infrastructure	(156,819)	(7,671)	—	5,086	(159,404)
Other equipment	(62,966)	(9,021)	—	3,822	(68,165)
Library materials	(27,668)	(1,530)	—	—	(29,198)
	<u>(257,363)</u>	<u>(19,059)</u>	<u>—</u>	<u>8,908</u>	<u>(267,514)</u>
Capital assets being depreciated, net	<u>173,714</u>	<u>751</u>	<u>27,961</u>	<u>(9,635)</u>	<u>192,791</u>
Capital assets, net	<u>\$ 247,875</u>	<u>48,863</u>	<u>—</u>	<u>(9,848)</u>	<u>286,890</u>

At September 30, 2007, the University had commitments of approximately \$55,408,000 related to various construction projects.

During the year ended September 30, 2007, the University sold Buildings II and III in the USA Technology and Research Park to the Corporation for proceeds of approximately \$11,986,000 and recognized a gain of approximately \$2,638,000.

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(b) USA Research and Technology Corporation

Changes in capital assets for the years ended September 30, 2008 and 2007 are as follows:

		2008				
		Beginning balance	Additions	Transfers	Reductions	Ending balance
Land improvements	\$	1,828	122	—	—	1,950
Buildings		22,228	1,874	—	—	24,102
Other equipment		—	173	—	—	173
		<u>24,056</u>	<u>2,169</u>	<u>—</u>	<u>—</u>	<u>26,225</u>
Less accumulated depreciation for:						
Land improvements		(292)	(89)	—	—	(381)
Buildings		(1,217)	(566)	—	—	(1,783)
Other equipment		—	(9)	—	—	(9)
		<u>(1,509)</u>	<u>(664)</u>	<u>—</u>	<u>—</u>	<u>(2,173)</u>
Capital assets, net	\$	<u>22,547</u>	<u>1,505</u>	<u>—</u>	<u>—</u>	<u>24,052</u>
		2007				
		Beginning balance	Additions	Transfers	Reductions	Ending balance
Land improvements	\$	1,524	306	(2)	—	1,828
Buildings		9,051	13,175	2	—	22,228
Other equipment		1	—	—	(1)	—
		<u>10,576</u>	<u>13,481</u>	<u>—</u>	<u>(1)</u>	<u>24,056</u>
Less accumulated depreciation for:						
Land improvements		(215)	(77)	—	—	(292)
Buildings		(660)	(557)	—	—	(1,217)
Other equipment		(1)	—	—	1	—
		<u>(876)</u>	<u>(634)</u>	<u>—</u>	<u>1</u>	<u>(1,509)</u>
Capital assets, net	\$	<u>9,700</u>	<u>12,847</u>	<u>—</u>	<u>—</u>	<u>22,547</u>

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(7) Noncurrent Liabilities

A summary of the University's noncurrent liability activity for the years ended September 30, 2008 and 2007 follows (in thousands):

	2008					
	<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:						
Note payable	\$ 1,456	—	(1,456)	—	—	—
Bonds payable	198,155	121,898	(3,819)	316,234	4,875	311,359
Capital lease payable	188	—	(96)	92	92	—
Total long-term debt	199,799	121,898	(5,371)	316,326	4,967	311,359
Other long-term liabilities	58,562	29,280	(22,372)	65,470	13,263	52,207
Total noncurrent liabilities	<u>\$ 258,361</u>	<u>151,178</u>	<u>(27,743)</u>	<u>381,796</u>	<u>18,230</u>	<u>363,566</u>
	2007					
	<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:						
Note payable	\$ 2,871	—	(1,415)	1,456	1,456	—
Bonds payable	118,821	107,325	(27,991)	198,155	3,820	194,335
Capital lease payable	277	—	(89)	188	95	93
Total long-term debt	121,969	107,325	(29,495)	199,799	5,371	194,428
Other long-term liabilities	60,150	23,693	(25,281)	58,562	10,208	48,354
Total noncurrent liabilities	<u>\$ 182,119</u>	<u>131,018</u>	<u>(54,776)</u>	<u>258,361</u>	<u>15,579</u>	<u>242,782</u>

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.

(8) Note and Bonds Payable

(a) University of South Alabama

Note Payable

Note payable consisted of the following at September 30, 2008 and 2007 (in thousands):

	<u>2008</u>	<u>2007</u>
Compass Bank limited obligation note, repaid in September 2008, unsecured	\$ —	1,456

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Bonds Payable

Bonds payable consisted of the following at September 30, 2008 and 2007 (in thousands):

	2008	2007
University Tuition Revenue Bonds, Series 1999 Current Interest, 3.70% to 4.35%, payable through November 2010	\$ 10,625	13,075
University Tuition Revenue Bonds, Series 1999 Capital Appreciation, 4.70% to 5.25%, payable November 2011 through November 2018	31,821	30,276
University Tuition Revenue Refunding and Capital Improvement Bonds, Series 2004, 2.00% to 5.00%, payable through March 2024	46,245	47,525
University Tuition Revenue Refunding and Capital Improvement Bonds, Series 2006, 5.00%, payable through December 2036	100,000	100,000
University Facilities Revenue and Capital Improvement Bonds, Series 2008, 3.00% to 5.00%, payable through August 2038	112,885	—
Borrowing arising from swaption, Series 2004 Bonds	1,524	—
Borrowing arising from swaption, Series 2006 Bonds	5,813	—
	308,913	190,876
Plus unamortized premium	8,354	8,566
Less unamortized discount	(69)	(75)
Less unamortized debt extinguishment costs	(964)	(1,212)
	\$ 316,234	198,155

Substantially all student tuition and fee revenues secure University bonds. Additionally, security for Series 2008 bonds includes Children's and Women's Hospital revenues in an amount not exceeding \$10,000,000. 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. Series 2006 Bonds begin maturing in December 2024 and are redeemable beginning in December 2016. Series 2008 Bonds begin maturing in August 2009 and are redeemable beginning in August 2018.

In January 2008, the University entered into a synthetic advance refunding of the outstanding Series 2004 and 2006 bonds. This transaction was effected through the sale of two swaptions by the University to a counterparty. The proceeds from each sale, totaling \$9,328,000 consist of two components, a time value and an intrinsic value. The intrinsic value of the payment is considered a borrowing and is included in long-term debt. As a result of this transaction, the counterparty has the option to force the University to redeem its Series 2004 and 2006 bonds at their respective redemption dates. See footnote five for a complete description of this transaction.

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During the years ended September 30, 2008 and 2007, the maturity value of the Capital Appreciation Bonds increased \$1,544,000 and \$1,468,000, respectively, over the original principal amount of \$19,810,000, reflecting accretion of interest.

During the year ended September 30, 2007, the University refunded the Series 1996 bonds with a portion of the proceeds from the issuance of the Series 1996 bonds. The 2006 refunding transaction resulted in an accounting loss totaling \$924,000, which has been deferred and is being amortized using the straight-line method through 2016. Aggregate cash flows from the refunding date through contractual maturity of the Series 1996 bonds totals approximately \$28,826,000, while aggregate cash flows from the portion of the refunding Series 2006 bonds applicable to the refunding totaled approximately \$48,588,000 through the maturity date of the Series 2006 bonds, resulting in a negative net cash flow differential for the refunding of approximately \$19,762,000. The economic gain (generally referred to as the present value of the net cash flow differential discounted at the effective interest rate of the new debt) on the 2006 refunding transaction totals approximately \$1,328,000.

Approximately \$34,852,000 of proceeds from the issuance of the Series 2006 Bonds remained unspent at September 30, 2008 (\$4,363,000 is included in restricted cash and cash equivalents and \$30,489,000 is included in restricted investments in the 2008 statement of net assets) and are restricted for capital purposes as outlined in the indenture.

Approximately \$110,325,000 of proceeds from the issuance of the Series 2008 Bonds remained unspent at September 30, 2008 (\$90,735,000 is included in restricted cash and cash equivalents and \$19,590,000 is included in restricted investments in the 2008 statement 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. There was no principal outstanding on defeased debt at September 30, 2008.

The University is subject to restrictive covenants, primarily certain operating ratios and other restrictive covenants, related to certain note and bonds payable. At September 30, 2008, 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 as of September 30, 2008 (in thousands):

	Debt service on bonds			
	Principal	Interest	Additional maturity	Total
2009	\$ 4,785	12,480	(1,998)	15,267
2010	5,715	12,700	(2,100)	16,315
2011	5,410	12,464	(2,207)	15,667
2012	6,995	12,324	(2,143)	17,176
2013	7,295	12,219	(2,039)	17,475
2014 – 2018	45,994	60,430	(6,223)	100,201
2019 – 2023	56,635	54,904	(49)	111,490
2024 – 2028	54,695	41,568	—	96,263
2029 – 2033	65,659	27,159	—	92,818
2034 – 2038	72,489	9,199	—	81,688
Subtotal	325,672	255,447	(16,759)	564,360
Plus (less):				
Additional maturity	(16,759)			
Unamortized bond premium	8,354			
Unamortized bond discount	(69)			
Unamortized debt extinguishment cost	(964)			
Total	\$ 316,234			

The principal amount of debt service due on bonds at September 30, 2008 includes \$13,469,000 representing additional maturity value on Series 1999 Capital Appreciation Bonds. These bonds mature in years 2011 through 2019 and are noninterest bearing. Also included in the principal amount of debt service due on bonds at September 30, 2008, is \$3,290,000 representing additional maturity value of the borrowing resulting from the Series 2004 and Series 2006 swaption. As described in note 5, additional maturity will continue to accrue until the swaption option period in 2014 and 2016. 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.

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(b) USA Research and Technology Corporation

Notes Payable

Notes payable consisted of the following at September 30, 2008 and 2007 (in thousands):

	2008	2007
Whitney National Bank commercial mortgage note, 6.0%, payable through 2014	\$ 9,178	9,528
Wachovia Bank, N.A. construction loan convertible into promissory note, one-month LIBOR plus 0.85% (6.515% at September 30, 2007)	—	13,429
Wachovia Bank, N.A. promissory note, one-month LIBOR plus 0.85% (4.776% at September 30, 2008), payable through 2028	17,853	—
	\$ 27,031	22,957

The note payable to Whitney National Bank is secured by all funds of the Corporation on deposit with Whitney National Bank, an interest in the ground lease with respect to the parcel of land on which Building I stands, an interest in Building I, an interest in the tenant lease for Building I, and an interest in income received from rental of Building I. The note has a ten-year term and amortization is based on a twenty-year term.

The construction loan payable to Wachovia Bank, N.A. was incurred by the Corporation to acquire Buildings II and III in the USA Technology & Research Park and to provide funds for renovations and tenant finishing costs. The maximum amount that might be borrowed under the construction loan was \$18,000,000. The loan was an interest-only loan until May 1, 2008, at which time the loan was converted to a fully amortizing promissory note with a twenty-year term. The Corporation has entered into two derivative instruments, an interest rate cap of 6.1% on the construction loan and a “receive variable, pay fixed” type of interest rate swap on the promissory note which will yield a synthetic fixed interest rate of 6.1%. The construction loan and the promissory note payable is secured by an interest in the ground lease with respect to the parcels of land on which Buildings II and III stand, an interest in Buildings II and III, an interest in tenant leases for Buildings II and III, and an interest in income received from rental of Buildings II and III. The University also entered into an agreement with Wachovia Bank, N.A. providing that, for a year in which the Corporation’s debt service coverage ratio is less than one to one, the University will pay the Corporation rent equal to the amount necessary to bring the ratio to one to one. At September 30, 2008, the Corporation’s management believes the Corporation was in compliance with its debt covenants.

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Debt Service on Long-Term Obligations

At September 30, 2008, total debt service by fiscal year is as follows (in thousands):

	Debt service on note and loan		
	Principal	Interest	Total
2009	\$ 858	1,624	2,482
2010	912	1,570	2,482
2011	969	1,513	2,482
2012	1,029	1,453	2,482
2013	1,095	1,387	2,482
2014 – 2018	10,781	4,221	15,002
2019 – 2023	5,045	2,755	7,800
2024 – 2028	6,342	965	7,307
Total	\$ 27,031	15,488	42,519

Derivative Transactions

On February 27, 2007, the Corporation entered into two derivative transactions with Wachovia Bank, N.A. The first transaction was an interest rate cap entered into in connection with the construction loan. The second transaction is a “receive variable, pay fixed” interest rate swap entered into in connection with the promissory note that came into effect upon conversion of the construction loan into a permanent loan on May 1, 2008.

Objectives of the derivative transactions. The Corporation utilized the interest rate cap to limit its variable rate exposure on the construction loan and utilizes the interest rate swap to convert its variable rate on the promissory note to a synthetic fixed rate.

Terms. The construction loan and the associated interest rate cap were entered into on July 17, 2007 and February 27, 2007, respectively. The interest rate cap terminated on May 1, 2008 when the loan was converted into a promissory note. The interest rate cap’s notional amount was equal to the construction loan balance and was limited to a maximum of \$18,000,000. The construction loan bore variable rate interest equal to the one-month London Interbank Offered Rate (LIBOR) plus 0.85%. When the variable rate exceeded 6.1%, the cap operated to cause the counterparty, Wachovia Bank, N.A., to pay the Corporation the difference between the variable rate and 6.1%. For the year ended September 30, 2008, the Corporation received \$6,345 under the interest rate cap agreement, which is reflected as a reduction of interest expense.

The promissory note came into effect on May 1, 2008 upon conversion of the construction loan. Also, on May 1, 2008, the interest rate swap associated with the loan became effective. The swap will terminate on May 1, 2028, when the loan matures. The notional amount of the swap will at all times match the outstanding principal amount of the loan. Under the swap, the Corporation pays the counterparty, Wachovia Bank, N.A., a fixed payment of 6.1% and receives a variable payment of the one-month LIBOR rate plus 0.85%. Conversely, the loan bears interest at the one-month LIBOR rate

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plus 0.85%. For the year ended September 30, 2008, the Corporation paid \$206,104 under the interest rate swap agreement, which is reflected as an increase in interest expense.

Fair value. The interest rate swap had a fair value at September 30, 2008 of \$(1,315,000).

Credit risk. As of September 30, 2008, the Corporation was not exposed to credit risk on the interest rate swap because it had a negative fair value. However, if interest rates change and the fair value of the derivatives become positive, the Corporation would have a gross exposure to credit risk in the amount of the fair value of the derivatives. The counterparty was rated AA- by Standard & Poor's Ratings Services as of September 30, 2008.

Termination risk. The interest rate swap contracts uses the International Swaps and Derivatives Association, Inc. Master Agreement, which includes standard default and termination events, such as failure to make payments, breach of agreement, and bankruptcy. Due to recent economic conditions, Wachovia Bank, N. A. is currently experiencing some financial difficulties and recently announced a proposed merger with Well Fargo & Company. Under the proposed transaction, Well Fargo & Company will acquire all of Wachovia Bank, N.A. and all its businesses and obligations including its preferred equity and indebtedness, and all its banking deposits. Due to inherent uncertainties, there is a risk that the merger will not be completed and Wachovia Bank, N.A. may not be able to perform under its obligations as the counterparty. At September 30, 2008, no events of default or termination had occurred. If the interest rate swap is terminated, interest rate risk associated with the variable rate debt would no longer be hedged. Also, if at the time of termination the interest rate swap had a net negative fair value, the Corporation would be liable to the counterparty for a payment equal to the interest rate swap's fair value. To allow the Corporation the maximum flexibility to manage the utilization of Buildings II and III while at the same time providing protection for the counterparty, the Corporation granted the counterparty a \$2,000,000 mortgage secured by an interest in the ground lease with respect to the parcel of land on which Building II stands, an interest in Building II, a security interest in Building II tenant leases and a security interest in income received from rental of Building II.

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Derivative payments and hedged debt. As interest rates fluctuate, variable rate debt interest and net derivative payments will fluctuate. Using interest rates as of September 30, 2008, debt service requirements by fiscal year of the variable rate debt and net derivative payments, assuming current interest rates remain the same are as follows (in thousands):

	Variable rate loan		Interest rate swap, net	Total
	Principal	Interest		
2009	\$ 484	842	233	1,559
2010	515	818	227	1,560
2011	547	793	220	1,560
2012	581	766	212	1,559
2013	618	738	204	1,560
2014 – 2018	3,721	3,194	885	7,800
2019 – 2023	5,045	2,158	598	7,801
2024 – 2028	6,342	756	210	7,308
Total	\$ 17,853	10,065	2,789	30,707

(9) Capital Lease Obligation

In September 2006, the University signed a three-year purchase agreement as a method of financing the purchase of certain computer equipment for the USA Hospitals.

Future minimum capital lease payments at September 30, 2008, are as follows (in thousands):

Year ending September 30:	
2009	\$ 94
	94
Less amounts representing interest	(2)
Net minimum lease payments	\$ 92

(10) 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 according 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 cost report for the USA Medical Center has been audited through 2006 and settled through 2005. The cost report for USA Children's and Women's Hospital has been audited through 2007 and settled through 2006. The cost report for USA Knollwood Hospital has been audited and settled through March 2006 and settled through September 2004. Revenue from the Medicare program accounted for approximately 15% of the Hospitals' net patient service revenue for the years ended September 30, 2008 and 2007, 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 2006. Revenue from the Blue Cross program accounted for approximately 20% and 18% of the Hospitals' net patient service revenue for the years ended September 30, 2008 and 2007, 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 29% and 32% of the Hospitals' net patient service revenue for the years ended September 30, 2008 and 2007, 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, 2008 and 2007 follows (in thousands):

	2008	2007
Gross patient service revenue	\$ 399,945	370,976
Less provision for contractual and other adjustments	125,674	97,998
Less provision for bad debts	72,668	67,641
	\$ 201,603	205,337

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Changes in estimates related to prior cost reporting periods resulted in an increase of approximately \$2,082,000 in net patient service revenue for the year ended September 30, 2008.

(11) Hospital Lease

In fiscal 2006, the University and Infirmiry Health System, Inc. (the Infirmiry) entered into a Lease Agreement (the Lease) in which the University agreed to lease certain land, buildings and equipment used in connection with the operation of its USA Knollwood Hospital campus to the Infirmiry. The lease is effective through March 2056 with an automatic renewal, for an additional forty-nine years, through March 2105; and may be canceled by the Infirmiry after the initial fifty-year term. Upon the expiration or termination of the lease, the assets, along with responsibility for the operation of such assets, will revert to the University and the University will pay the Infirmiry, at fair market value, for any capital improvements to the assets. Additionally, the lease may be terminated at any time, at the option of the Infirmiry, in the event that a change in any law, statute, rule, or a regulation of any governmental or other regulatory body or any third-party payment program is deemed by the Infirmiry to be significant, as defined by the lease. University management does not anticipate that this option will be exercised by the Infirmiry.

The total amount of lease payments due the University was based on the fair market value of the appraised assets, \$32,418,000. The allocation of the appraised fair market value was \$29,370,000 for the land and buildings and \$3,048,000 for medical equipment, office furnishings and other equipment.

Upon execution of the lease, a partial lease prepayment in the amount of \$7,418,000 was made by the Infirmiry. In addition to the prepayment, required lease payments by the Infirmiry to the University are as follows (payable monthly):

- Years one through five of the initial lease term – \$1,000,000 annually
- Years six through ten of the initial lease term – \$1,250,000 annually
- Years eleven through fifteen of the initial lease term – \$1,500,000 annually
- Years sixteen through thirty of the initial lease term – The monthly payment will be the remaining unpaid balance of the lease payments amortized over years sixteen through thirty using an interest rate calculated from the immediately previous 15-year monthly average of the 20-year state and local tax exempt general obligation bond issues as determined by the United States Federal Reserve System. The remaining unpaid balance at the end of year fifteen, \$17,401,000, is derived by taking the initial unpaid balance of rent due after the partial lease prepayment, \$25,000,000 plus accrued interest at an annual rate of 3.75%, less monthly lease payments.
- Years thirty-one through fifty of the initial lease term – \$1 annually
- Year fifty-one through ninety-nine of the extended lease term – \$1 annually

For reporting purposes, management assumed that the interest rate utilized in years sixteen through thirty would remain at 3.75%. This assumption will be reviewed, and amortization schedules adjusted, if necessary, when the actual interest rate is determined.

In order to properly report this transaction, the University has bifurcated the lease into an equipment component and a real property component, as required by FASB Statement No. 13, based on the appraised

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fair value of each such component. The financial considerations of the lease are then applied to, and the accounting treatment is determined for, each component based on this bifurcation.

The equipment component of the lease is considered a capital lease (sales-type lease) and as such has been recorded as a capital lease receivable, both current and noncurrent, in the accompanying basic financial statements of the University. The capital equipment lease is being amortized through fiscal 2011 at a fixed rate of 3.75%. Future receipts from this capital lease are expected as follows:

Year ending September 30:		
2009	\$	515,000
2010		515,000
2011		257,000
		1,287,000
Less amounts representing interest		(61,000)
Total capital lease receivable	\$	1,226,000

The component of the lease attributable to land and buildings is considered an operating lease. As such, lease revenue will be recorded as it is earned over the ninety-nine year lease term (the fifty-year initial term and the forty-nine year automatic renewal term). The expected total lease payments to be received over the next twenty-eight years are approximately \$41,393,000. These total receipts will be recognized as revenue in the amount of approximately \$485,000 annually. Payments received in excess of this amount, along with cash and other consideration already received in the amount of \$6,721,000, will be deferred and amortized over the ninety-nine year lease term.

(12) 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.

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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 2008, 2007 and 2006, the University made total contributions of \$30,252,000, \$22,023,000, and \$18,468,000 (100% of the required contributions), respectively, to TRS on behalf of participants, which represents 11.06%, 9.36%, and 8.17%, respectively, of each participant's gross earnings. The University's payroll for all employees was approximately \$288,477,000 and \$264,021,000 in 2008 and 2007, respectively. Total payroll for University employees participating in the Teachers' Retirement System of Alabama was approximately \$257,466,000 and \$235,285,000 in 2008 and 2007, 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 \$951,000 and \$907,000 in 2008 and 2007, respectively, representing 457 and 427 employees participating in this Plan.

(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 \$16,197,000 and \$15,105,000 at September 30, 2008 and 2007, 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, 2008 and 2007, the University's expense related to PEEHIP was \$4,842,000 and \$5,167,000, respectively.

(13) 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.

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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, 2008 and 2007. 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 \$1,521,000 and \$1,296,000 in 2008 and 2007, 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.

The changes in the total self-insurance liabilities for the years ended September 30, 2008 and 2007 for the PLTF, GLTF and health plan are summarized as follows (in thousands):

	2008	2007
Balance, beginning of year	\$ 33,956	35,854
Liabilities incurred and other additions	43,382	41,200
Claims, administrative fees paid and other reductions	(40,055)	(43,098)
Balance, end of year	\$ 37,283	33,956

(14) Other Related Party

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 \$1,556,000 and \$1,326,000 in 2008 and 2007, respectively, and are reflected as private grants and contracts in the accompanying statements of revenues, expenses, and changes in net assets.

(15) Commitments and Contingencies

(a) Grants and Contracts

At September 30, 2008 and 2007, the University had been awarded approximately \$52,337,000 and \$48,103,000, 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 Federal agencies. The University's management believes any adjustment from such audits will not be material.

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(b) Letter of Credit

In connection with the Hospitals' participation in the State of Alabama Medicaid Program, the University has established a \$1,400,000 irrevocable standby letter of credit with Wachovia Bank. 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, 2008 and 2007.

(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.

(d) Rent Supplement Agreement

During the 2008 fiscal year, the University entered into an irrevocable rent supplement agreement with the Corporation and a financial institution. The agreement requires that, in the event the Corporation fails to maintain a debt service coverage ratio of one to one with respect to all of its outstanding indebtedness, the University will pay to the Corporation any and all rent amounts necessary to cause the Corporation's net operating income to be equal to the Corporation's annual debt service obligations (see note 8(b)). As of September 30, 2008, no amounts were payable pursuant to this agreement.

(e) State Bond Issues

The State of Alabama has made allocations to the University from bonds issues in prior years. Pursuant to these allocations, approximately \$21,332,000 is available to the University for certain future construction costs. The allocations have not been reflected in the accompanying financial statements.

(f) USA Research and Technology Corporations Leases

The Corporation leases space in Building I to a single tenant under an operating lease. The lease has a ten-year initial term with two five-year renewal options. Under the lease, the tenant must also pay, or reimburse to the Corporation for expenses paid by the Corporation, property taxes on the building, common area maintenance, utilities, and general liability and property damage insurance. In 2009, the lease calls for a one-time increase in monthly rent of 4%. Beginning on November 1, 2008, after providing a one-year advance notice, the tenant has the annual noncumulative option to terminate up to 10% of the square footage covered under the lease. Such advance notice was not received by November 1, 2007 or 2008.

Space in Buildings II and III is leased under operating leases to the University and various other tenants. Space under lease to the University was 51,662 and 45,034 square feet at September 30, 2008 and 2007, respectively. Under these leases, the Corporation must pay all operating expenses of the buildings, including utilities, janitorial, maintenance, property taxes, and insurance. Tenants will reimburse the Corporation for such expenses only as the total expenses for a year increase over the

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

Notes to Basic Financial Statements

September 30, 2008 and 2007

total expenses for the base year of the lease (the Corporation's fiscal year beginning after the date the lease is signed). The leases have terms varying from one to ten years.

The Corporation had three and two ground leases in place at September 30, 2008 and 2007, respectively. One lease is for a forty-year initial term with twenty-year and fifteen-year renewal options. The second lease is for a thirty-year initial term with four five-year renewal options. The first and second leases were in effect for the whole of each of the years ended September 30, 2008 and 2007. The third lease was entered into on March 14, 2008 and has a thirty-eight and one-half year initial term with twenty-year and fifteen-year renewal options.

Minimum future rentals by fiscal year are as follows (in thousands):

2009	\$	3,476
2010		3,337
2011		3,188
2012		2,750
2013		2,107
2014 - 2046		10,189
	\$	25,047

(16) Functional Information

Operating expenses by functional classification for the years ended September 30, 2008 and 2007 are listed below (in thousands). In preparing the basic financial statements, all significant transactions and balances among accounts have been eliminated.

		2008	2007
Instruction	\$	115,044	104,904
Research		21,275	20,224
Public service		39,202	42,140
Academic support		13,557	11,901
Student services		23,249	20,653
Institutional support		29,992	26,913
Operation and maintenance of plant		24,934	18,804
Scholarships		1,425	1,218
Hospital		229,162	194,336
Auxiliary enterprises		16,088	15,576
Depreciation and amortization		20,168	19,059
Other		—	5,234
	\$	534,096	480,962

UNIVERSITY OF SOUTH ALABAMA
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Notes to Basic Financial Statements

September 30, 2008 and 2007

(17) Significant New Accounting Pronouncements

In November 2006, the GASB issued Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB Statement No. 49 addresses accounting and reporting standards for pollution remediation obligations, which are obligations with respect to current operations and will be effective for the year ending September 30, 2009. In June 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB Statement No. 51 requires that certain intangible assets be classified and reported as capital assets and will be effective for the year ending September 30, 2010. In November 2007, the GASB issued Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*. GASB Statement No. 52 establishes standards for the reporting of land and other real estate held as investments and will be effective for the year ending September 30, 2009. In June 2008, the GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB Statement No. 53 addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments and will be effective for the year ending September 30, 2010.

The effect of the implementation of GASB Statements Nos. 49, 51, 52 and 53 on the University has not been determined.

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

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)
Schedule of Expenditures of Federal Awards
Year ended September 30, 2008

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Pass-through entity identifying number	Federal expenditures
Student Financial Aid Cluster*:			
U.S. Department of Education:			
Federal Pell Grant Program	84.063		\$ 9,331,972
Federal Supplemental Educational Opportunity Grant Program	84.007		466,356
Federal Family Educational Loan Program	84.032		64,474,598
Federal Work Study Program	84.033		264,498
Academic Competitiveness Grant	84.375		151,775
National Science and Mathematics Access to Retain Talent Grant	84.376		128,650
Total Student Financial Aid Cluster			<u>74,817,849</u>
Research and Development Cluster*:			
Direct awards:			
U.S. Department of Health and Human Services:			
Biological Response to Environmental Health Hazard	93.113		499,726
Research Related to Deafness and Communicative Disorders	93.173		107,719
Comparative Medicine	93.306		139,459
Minority Health and Health Disparities Research	93.307		797,156
International Research and Research Training	93.989		14,410
Cancer Cause and Prevention Research	93.393		289,229
Cancer Detection and Diagnosis Research	93.394		59,370
Cancer Treatment Research	93.395		137,009
Cancer Biology Research	93.396		330,198
Allergy, Immunology and Transplantation Research	93.855		605,885
Cardiovascular Diseases Research	93.837		1,507,187
Health Activities Recommendation Panel	93.203		6,433
Lung Diseases Research	93.838		4,215,735
Diabetes Endocrinology and Metabolism Research	93.847		206,406
Biomedical Research and Research Training	93.859		272,035
Extramural Research Programs in Neurosciences and Neurological Disorders	93.853		186,385
Microbiology and Infectious Diseases Research	93.856		1,233,784
National Center for Research Resources	93.389		253,716
Aging Research	93.866		(209)
Specially Selected Health Projects	93.888		(2,399)
National Science Foundation:			
Mathematical and Physical Sciences	47.049		275,828
Geosciences	47.050		129,613
Engineering Grants	47.041		12,811
Computer and Information Science and Engineering	47.070		72,145
Biological Sciences	47.074		17,943
Social, Behavioral, and Economic Sciences	47.075		4,152
Polar Programs	47.078		13,708
National Aeronautics and Space Administration:			
Technology Transfer	43.002		1,190,509
Environmental Protection Agency:			
Office of Research and Development Consolidated Research/ Training/Fellowships	66.511		746,704
U.S. Department of Commerce:			
Habitat Conservation	11.463		1,224,079
Applied Meteorological Research	11.468		796,713
Marine Fisheries Initiative	11.433		17,275
U.S. Department of Defense:			
Military Medical Research and Development	12.420		158,984

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)
Schedule of Expenditures of Federal Awards
Year ended September 30, 2008

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Pass-through entity identifying number	Federal expenditures
U.S. Department of Energy: Basic Energy Sciences University and Science	81.049		\$ 33,555
U.S. Department of Transportation: Highway Planning and Construction University Transportation Centers Program	20.205 20.701		161,013 17,905
U.S. Department of Interior: National Cooperative Geologic Mapping Program Conservation Grants Private Stewardship for Imperiled Species	15.810 15.632		3,795 12,446
U.S. Department of Justice: Developing, Testing and Demonstrating Promising New Programs	16.541		232,455
Total direct awards			<u>15,980,867</u>
Pass-through awards:			
Pass-through from National Institutes of Health**:			
Alabama Department of Public Health	93.283	C60114233	2,721
Columbia University	93.242	RO1 MH075026-02	49,438
Columbia University	93.853	70190	1,002
Duke University Medical Center	93.395	7U10CA76001-4	392
University of Colorado	93.838	FY07.032.008	90,006
M. D. Anderson Cancer Center	93.389	20526-98010395	461,070
University of Alabama Birmingham	93.113	UAB LINK NO -238575-04	18,208
University of Miami	93.853	UO1 NS0404060	8,802
University of Texas	93.853	116447/115709-02	35,304
University of Texas	93.855	U1 UO1 A1071283-03	108,088
National Childhood Cancer Foundation	93.395	UO1 CA98543-04 /AGREE#9854	(8,625)
Rhode Island Hospital	93.854	RO1 NS39131-01	2,393
Westat, Inc.	93.395	No2-CM-97024	6,858
Yale University	93.853	AO5648	162,266
Rockefeller University	93.839	5RO1HL019278-29	(645)
Rho, Inc	93.839	CHECK #23854	26,226
Mayo Foundation for Medical Research	93.853	SWISS	584
University of Alabama at Birmingham	93.856	5401 A141025-09	(139)
Pass-through from Administration for Children and Family**:			
Alabama Council for Developmental Disabilities	93.630	80040	72,145
Pass-through from National Science Foundation:			
University of Georgia	47.074	RR100-391/8920207	25,307
University of Georgia	47.050	1021RR100513 -3506498	31,074
University of Alabama in Huntsville	47.076	SUB2005-291	31,545
Alabama A&M University	47.076	AAMURI-08-C-0009	25,000
Tuskegee University	47.076	34-21530-038-621	69,874
University of Alabama	47.076	06-006	2,988
Bigelow Laboratory for Ocean Sciences	47.078	BLOS 2003-2	45,523
Pass-through from National Aeronautics and Space Administration:			
University of Alabama in Huntsville	43.002	SUB2005-152-A5	18,721
University of Mississippi	43.002	08-08-025	48,294
Pass-through from U.S. Veterans Administration:			
Civil Consultants, Inc.	64.201	70358	12,673

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)
Schedule of Expenditures of Federal Awards
Year ended September 30, 2008

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Pass-through entity identifying number	Federal expenditures
Pass-through from U.S. Department of Commerce:			
Alabama Department of Conservation and Natural Resources	11.454	80182	\$ 208,889
Prince William Sound Science Center	11.472	04-PWSSC 07-46-0	28,820
University of Mississippi	11.430	08-04-068	17,556
University of Southern Mississippi	11.417	USM-GRO2639/ OMNIBUS-R/SP	12,680
Pass-through from National Oceanographic and Atmospheric Association:			
Prince William Sound Science Center	11.472	04-PWSSC 06-52-07	4,778
Pass-through from U.S. Department of Transportation:			
Kilgore Consulting Management	20.215	DTFH61-01-R-00063	4,781
Pass-through from Environmental Protection Agency:			
Mobile Water and Sewer Service	66.606	MOBILE WATER	(9,425)
Pass-through from U. S. Department of Interior:			
Alabama Historical Commission	15.904	AL-06-003	92,916
Louisiana State University	15.235	SUBCONTRACT C164107	21,248
Pass-through from U.S. Department of Defense:			
Trinity University	12.800	FA9550-06-1-1029	51,805
Aerostar Environmental Services, Inc.	12.104	0407-524-31	88,540
Auburn University	12.431	04-ME-420950-USA	962
Pass-through from U.S. Department of Housing and Urban Development:			
Washington County Commission	14.228	CDBG/HUD	6,643
Total pass-through awards			1,877,286
Total Research and Development Cluster			17,858,153
Other federal assistance:			
Direct awards:			
U.S. Department of Education:			
TRIO Talent Search	84.044		297,837
TRIO Upward Bound	84.047		198,109
Transition to Teaching	84.350		227,777
U.S. Department of Health and Human Services:			
Advanced Education Nursing Grant Programs*	93.247		3,350,449
Basic Nurse Education and Practice Grants	93.359		202,677
Health Resources and Services Administration**:			
Grants for Residency Training for General Pediatrics	93.884		217,570
Telehealth Network Grants	93.211		210
HIV Demonstration Program for Children	93.153		317,290
Professional Nurse Traineeships	93.358		244,684
Project Grants for Renovation or Construction	93.887		15,378,565
Center for Disease Control and Prevention**:			
Centers for Disease Control and Prevention	93.283		11,761
U.S. Department of Housing and Urban Development:			
Community Development Block Grants	14.246		(797)
National Science Foundation:			
Education and Human Resources	47.076		98,395
Biological Sciences	47.074		47,108

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)
Schedule of Expenditures of Federal Awards
Year ended September 30, 2008

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Pass-through entity identifying number	Federal expenditures
Americorp: Corporation of National and Community Service	94.006		\$ 23,105
U.S. Department of Commerce: Coastal Zone Management Estuarine Research	11.420		6,618
U.S. Department of Transportation: National Motor Carrier Safety	20.218		408,908
Total direct awards			<u>21,030,266</u>
Pass-through awards:			
Pass-through from U.S. Department of Education:			
Alabama Department of Education	84.027	80035	20,000
Alabama Department of Education	84.323	C7U0133	82,090
Alabama Department of Education	84.357	370684-005503 -170030-1	310,145
Auburn University	84.287	08-TPI-222015-USA	16,675
Alabama Commission of Higher Education	84.367	50406	188,440
National Writing Project	84.928	NAT'L WRITING PROJECT	55,595
Pass-through from NASA:			
University of Alabama in Huntsville	43.002	SUB2005	18,467
Pass-through from National Institutes of Health**:			
Mayo Foundation for Medical Research	93.853	RO1 NS039987-7	1,993
Medical Library Association	93.879	CHECK #12461	2,286
SEA National Network of Libraries	93.879	80203	1,821
Moorehouse School of Medicine	93.004	US2MP002001-03-4	15,387
University of Maryland Baltimore	93.879	070106-MOA	3,505
United Way of Central Alabama	93.917	RW-USAF-0809	16,968
Pass-through from States Administration on Aging**:			
South Alabama Regional Planning Commission	93.051	80273	4,435
Pass-through from Administration for Children and Families:			
University of Alabama	93.658	80055	55,543
Pass-through from Health Resources Services Administration**:			
Alabama Department of Public Safety	93.289	C70119129	38,272
Alabama Department of Public Health	93.889	C80117142	538,285
Alabama Department of Public Health	93.289	C60114173	260,277
Alabama Department of Public Health	93.926	C80117121	20,000
Florida State University	93.969	R00891	58,881
Pass-through from National Science Foundation:			
University of Alabama at Birmingham	47.076	0602359-011-A1	25,620
Pass-through from U.S. Department of Justice:			
Alabama Department of Public Safety	16.579	60429	(373)
Alabama Department of Public Safety	16.579	17PGCP5042	1,844
Pass-through from U. S. Small Business Administration:			
University of Alabama at Birmingham	59.037	SBA FY2007-2008	127,529

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)
Schedule of Expenditures of Federal Awards
Year ended September 30, 2008

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Pass-through entity identifying number	Federal expenditures
Pass-through from U.S. Department of Defense: University of Alabama Birmingham	12.002	DOD 07-70	\$ <u>23,599</u>
Total pass-through awards			<u>1,887,284</u>
Total other federal assistance			<u>22,917,550</u>
Total federal expenditures			<u>\$ <u>115,593,552</u></u>

* Denotes major program.

** Denotes a subagency of the U.S. Department of Health and Human Services.

See accompanying notes to schedule of expenditures of federal awards.

See accompanying independent auditors' report on supplementary information.

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

Notes to Schedule of Expenditures of Federal Awards

September 30, 2008

(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 U.S. generally accepted accounting principles. 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 in the accompanying schedule of expenditures of federal awards, except for Perkins Loans, Federal Family Educational Loan (FFEL) Programs, Health Professional Student 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, 2008. The loan programs representing loans made by the University are included in notes receivable in the accompanying 2008 statement of net assets and consist of the following:

Perkins Loan Program	\$	4,415,267
Loans to Disadvantaged Students		1,727
Health Professional Student Loans		103,380
		4,520,374
Less outstanding balance of loans granted in previous years		(4,520,374)
New loans granted to eligible students of the University	\$	—

The FFEL and HEAL federal awards represent loans received by students of the University during fiscal year 2008 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.

(3) Federal Family Education Loan Programs

During fiscal year ended September 30, 2008, the University processed the following amount of new loans under the Federal Family Education Loan Program:

	CFDA #	Amount expended
Subsidized Stafford loans	84.032	\$ 25,246,435
Unsubsidized Stafford loans	84.032	36,441,749
Parents' Loans for Undergraduate Students	84.032	2,786,414
Total		\$ 64,474,598

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

Notes to Schedule of Expenditures of Federal Awards

September 30, 2008

(4) Administrative Cost Allowance

The accompanying schedule of expenditures of federal awards includes administrative costs for the Federal Work Study program of \$45,680.

(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:

	Federal CFDA #	Amounts expended
Direct awards:		
Habitat Conservation	11.463	\$ 550,407
National Motor Carrier Safety	20.218	40,000
Office of Research and Development Consolidated Research/ Training/Fellowships	66.511	306,001
Highway Planning and Construction	20.205	(21,230)
Technology Transfer	43.002	437,728
Mathematical and Physical Sciences	47.049	9,010
Transition to Teaching	84.350	69,873
International Research and Research Training	93.989	43,171
Cancer Biology Research	93.396	65,287
Biological Sciences	47.074	96
HIV Demonstration Program for Children	93.153	4,838
Applied Meteorological Studies	11.468	58,157
Minority Health and Health Disparities Research	93.307	109,979
Biomedical Research and Research Training	93.859	31,683
University Transportation Centers Program	20.701	2,500
Pass-through awards:		
Health Resources Services Administration/Alabama Department of Public Health	93.926	20,000
U.S. Department of Education/Alabama Commission of Higher Education	84.367	288,257
U.S. Department of Education/Alabama Department of Education	84.357	5,142
U.S. Veterans Administration/Civil Consultants, Inc.	64.201	3,000
		\$ 2,023,899

(6) Matching

Under the Federal Work Study Program and Federal Supplemental Educational Opportunity Grant Program, the University matched \$66,721 and \$148,269, respectively, in funds awarded to students for the year ended September 30, 2008 in addition to the Federal share of expenditures included in the accompanying schedule of expenditures of federal awards.



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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, 2008, and have issued our report thereon dated November 14, 2008. We did not audit the 2008 consolidated financial statements of the University of South Alabama Foundation, which represents 82%, 100%, and (14)%, respectively, of the assets, net assets and revenues, gains and other support 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. The financial statements of the University of South Alabama Foundation, the University of South Alabama Health Services Foundation, the USA Research and Technology Corporation, and the Professional and General Liability Trust Funds were not audited in accordance with *Government Auditing Standards*.

Internal Control over Financial Reporting

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

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

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



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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether 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*.

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 14, 2008



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**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, 2008, except the requirements discussed in the second paragraph of this report. 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 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 in accordance with the requirements of the Student Financial Assistance Cluster: Federal Perkins Loan program as described in the Compliance Supplement. Those requirements govern functions 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 for the year ended September 30, 2008 was examined by accountants for the servicer in accordance with the U.S. Department of Education's Audit Guide, *Audits of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*. Our report does not include the results of the accountants for the servicer's examination of ACS's compliance with such requirements.

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 described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* 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 in the first paragraph above that are applicable to each of its major federal programs for the year ended September 30, 2008. However, the results of our auditing procedures disclosed an instance of noncompliance with those requirements, which is required to be reported in accordance with OMB Circular A-133 and which is described in the accompanying schedule of findings and questioned costs as item 2008-01.

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 the 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, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the University's internal control over compliance.

Requirements governing maintaining contact with and billing borrowers and processing deferment and cancellation requests and payments for the Federal Perkins Loan program in the Student Financial Assistance Cluster: Federal Perkins Loan program as described in the Compliance Supplement are performed by ACS. Internal control over compliance related to such functions for the year ended September 30, 2008 was reported on by accountants in accordance with the U.S. Department of Education's Audit Guide, *Audits of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*. Our report does not include the results of the accountants for the servicer's testing of the University's internal control over compliance related to such functions.

A control deficiency in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control.

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

The University's response to the finding identified in our audit is described in the accompanying schedule of findings and questioned costs. We did not audit the University's response, and accordingly, we express no opinion on it.



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 14, 2008

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)
Schedule of Findings and Questioned Costs
Year ended September 30, 2008

I – Summary of Auditor’s Results

Financial Statements

Type of auditors’ report issued: Unqualified

Internal control over financial reporting:

Material weakness(es) identified? _____ yes x no

Significant deficiency(ies) 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

Significant deficiency(ies) identified that are:
not considered to be material weaknesses? _____ yes x none reported

Type of auditors’ report issued on compliance for
major programs: 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:

CFDA Numbers	Name of Federal Program Cluster
84.063, 84.007, 84.032, 84.033, 84.375, 84.376	Student Financial Aid Cluster
Various	Research and Development Cluster
93.247	U.S. Department of Health and Human Services / Advanced Education Nursing Grant Programs
Dollar threshold used to distinguish between type A and type B programs:	_____ <u> \$ 3,000,000 </u>
Auditee qualified as low-risk auditee?	_____ <u> x </u> yes _____ no

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)
Schedule of Findings and Questioned Costs
Year ended September 30, 2008

**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
(A Component Unit of the State of Alabama)
Schedule of Findings and Questioned Costs
Year ended September 30, 2008

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

Finding No. 2008-01 Allowable Costs / Activities Allowed

Federal Agency:

U.S. Department of Health and Human Services

CFDA Number:

93.247

Program:

Advanced Education Nursing Grants

Award Numbers:

5D09HP05319-03-00
5D09HP00231-07-00
1D09HP07984-01-00
1D09HP07971-01-00
6D09HP07965-01-01
5D09HP07319-02-00
5D09HP07330-02-00
5D09HP07329-02-00
5D09HP07325-02-00
5D09HP05321-02-00
1D09HP05319-01-00
5D09HP05321-03-00

Award Years:

July 1, 2007 through June 30, 2009

Criteria

OMB Circular A-21 (A-21) establishes principles for determining the costs applicable to activities performed by educational institutions under grants, contracts, and other agreements with the Federal Government. In accordance with A-21, direct costs charged to Federal grants must be for allowable costs.

Condition

During our testwork related to the Advanced Education Nursing Grants Program, we noted that certain costs charged to these grants were unallowable. The amount of costs determined to be unallowable was \$33,140, which includes \$2,455 of indirect costs. Total program costs totaled \$3,350,449 for the year ended September 30, 2008.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)
Schedule of Findings and Questioned Costs
Year ended September 30, 2008

Questioned Costs

\$33,140 (unallowable costs)

Context

The grant documents allowed for fringe benefits to be charged to the Federal grants. The University charged tuition and scholarships offered as a fringe benefit as a direct cost to the Federal grants. However, the summary information for the program in the Catalog of Federal Domestic Assistance (CFDA) stated that student support through stipends, tuition, and fees was not eligible for support under this Federal program and therefore these costs were unallowable.

Cause and Effect

Management of the University was unaware that tuition and scholarships are not allowable as fringe benefits. As a result, Federal funds were expended for unallowable purposes.

Recommendation

We recommend that management strengthen the University's processes and controls to ensure that the CFDA program information is reviewed in conjunction with the grant documents in determining allowable costs.

Management Views

Management concurs with the finding. Management will strengthen controls over disbursements related to tuition by providing education to the Business Office that reviews these transactions. The Grants and Contracts Accounting Office will review new grants to determine whether tuition is allowable, and if not, will review the account monthly to verify that no tuition is charged.