

UNIVERSITY OF SOUTH ALABAMA FOUNDATION

*Disproportionate Share Hospital Funds
Combined Financial Statements as of and
for the Years Ended June 30, 2008 and 2007, and
Independent Auditors' Report*

UNIVERSITY OF SOUTH ALABAMA
FOUNDATION

**DISPROPORTIONATE SHARE HOSPITAL FUNDS
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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
University of South Alabama Foundation:

We have audited the accompanying combined statements of financial position of the Disproportionate Share Hospital Funds (the "DSH Funds") of the University of South Alabama Foundation (the "Foundation") as of June 30, 2008 and 2007, and the related combined statements of activities and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the DSH Funds' 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 provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the combined financial position of the DSH Funds at June 30, 2008 and 2007, and the related activities and changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.



August 18, 2008

UNIVERSITY OF SOUTH ALABAMA
FOUNDATION

**DISPROPORTIONATE SHARE HOSPITAL FUNDS
 COMBINED STATEMENTS OF FINANCIAL POSITION
 AS OF JUNE 30, 2008 AND 2007
 (Dollars in thousands)**

ASSETS	2008	2007
INVESTMENTS:		
New Investment Pool—at fair value	\$ 131,794	\$ 140,903
Real estate	4,000	9,827
RECEIVABLE FROM AFFILIATES	459	3,716
OTHER ASSETS	<u>-</u>	<u>8</u>
TOTAL	<u>\$ 136,253</u>	<u>\$ 154,454</u>
 LIABILITIES AND NET ASSETS		
LIABILITIES		
	<u>\$ -</u>	<u>\$ 7</u>
NET ASSETS:		
Unrestricted	(1,505)	(1,165)
Temporarily restricted	6,172	24,026
Permanently restricted	<u>131,586</u>	<u>131,586</u>
Total net assets	<u>136,253</u>	<u>154,447</u>
TOTAL	<u>\$ 136,253</u>	<u>\$ 154,454</u>

See notes to combined financial statements.

UNIVERSITY OF SOUTH ALABAMA
FOUNDATION

**DISPROPORTIONATE SHARE HOSPITAL FUNDS
 COMBINED STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS
 FOR THE YEAR ENDED JUNE 30, 2008
 (Dollars in thousands)**

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES, GAINS, AND OTHER SUPPORT:				
Net realized and unrealized losses on investments	\$ (271)	\$ (13,117)	\$ -	\$ (13,388)
Interest and dividends	17	1,057	-	1,074
Rental income	10	-	-	10
Interfund interest	5	390	-	395
Net assets released from program restrictions	<u>6,184</u>	<u>(6,184)</u>	<u>-</u>	<u>-</u>
Total revenues, gains, and other support	5,945	(17,854)	-	(11,909)
EXPENDITURES:				
Program services:				
Scholarships	8	-	-	8
Other academic programs	<u>5,553</u>	<u>-</u>	<u>-</u>	<u>5,553</u>
Total program services	5,561	-	-	5,561
Other investment expense	<u>724</u>	<u>-</u>	<u>-</u>	<u>724</u>
Total expenditures	<u>6,285</u>	<u>-</u>	<u>-</u>	<u>6,285</u>
DECREASE IN NET ASSETS	(340)	(17,854)	-	(18,194)
NET ASSETS AT BEGINNING OF YEAR	<u>(1,165)</u>	<u>24,026</u>	<u>131,586</u>	<u>154,447</u>
NET ASSETS AT END OF YEAR	<u>\$ (1,505)</u>	<u>\$ 6,172</u>	<u>\$ 131,586</u>	<u>\$ 136,253</u>

See notes to combined financial statements.

UNIVERSITY OF SOUTH ALABAMA
FOUNDATION

**DISPROPORTIONATE SHARE HOSPITAL FUNDS
 COMBINED STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS
 FOR THE YEAR ENDED JUNE 30, 2007
 (Dollars in thousands)**

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES, GAINS, AND OTHER SUPPORT:				
Net realized and unrealized gains on investments	\$ 1,254	\$ 10,708	\$ -	\$ 11,962
Interest and dividends	212	1,793	-	2,005
Interfund interest	40	551	-	591
Net assets released from program restrictions	<u>3,334</u>	<u>(3,334)</u>	<u>-</u>	<u>-</u>
Total revenues, gains, and other support	<u>4,840</u>	<u>9,718</u>	<u>-</u>	<u>14,558</u>
EXPENDITURES:				
Program services:				
Other academic programs	<u>3,015</u>	<u>-</u>	<u>-</u>	<u>3,015</u>
Total program services	3,015	-	-	3,015
Other investment expense	<u>379</u>	<u>-</u>	<u>-</u>	<u>379</u>
Total expenditures	<u>3,394</u>	<u>-</u>	<u>-</u>	<u>3,394</u>
INCREASE IN NET ASSETS	1,446	9,718	-	11,164
NET ASSETS AT BEGINNING OF YEAR	<u>(2,611)</u>	<u>14,308</u>	<u>131,586</u>	<u>143,283</u>
NET ASSETS AT END OF YEAR	<u>\$ (1,165)</u>	<u>\$ 24,026</u>	<u>\$ 131,586</u>	<u>\$ 154,447</u>

See notes to combined financial statements.

UNIVERSITY OF SOUTH ALABAMA
FOUNDATION

**DISPROPORTIONATE SHARE HOSPITAL FUNDS
 COMBINED STATEMENTS OF CASH FLOWS
 FOR THE YEARS ENDED JUNE 30, 2008 AND 2007
 (Dollars in thousands)**

	2008	2007
OPERATING ACTIVITIES:		
(Decrease) increase in net assets	\$ (18,194)	\$ 11,164
Adjustments to reconcile increase (decrease) in net assets to net cash used in operating activities:		
Net unrealized loss (gain) on investments	12,245	(10,369)
Loss (gain) loss on sale of investments	1,143	(1,594)
Changes in operating assets and liabilities:		
Accounts receivable	-	-
Interfund receivable	2,765	(217)
Other assets	8	(2)
Accounts payable		(1)
Other liabilities	(7)	4
Net cash used in operating activities	<u>(2,040)</u>	<u>(1,015)</u>
INVESTING ACTIVITIES:		
Purchases of securities	(6,836)	(2,437)
Sale of securities	3,476	3,452
Proceeds from sale of real estate	5,400	-
Net cash provided by investing activities	<u>2,040</u>	<u>1,015</u>
NET CHANGE IN CASH AND CASH EQUIVALENTS	<u>-</u>	<u>-</u>
CASH AND CASH EQUIVALENTS—Beginning of year	<u>-</u>	<u>-</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ -</u>	<u>\$ -</u>

See notes to combined financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION

DISPROPORTIONATE SHARE HOSPITAL FUNDS NOTES TO COMBINED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED JUNE 30, 2008 AND 2007 (DOLLARS IN THOUSANDS)

1. ORGANIZATION

The University of South Alabama Foundation (the “Foundation”) was incorporated in March 1968 for the purpose of promoting education, scientific research, and charitable purposes, and to assist in developing and advancing the University of South Alabama (the “University”) in furthering, improving, and expanding its properties, services, facilities, and activities. Revenues are derived principally from investment income and contributions.

The Disproportionate Share Hospital Funds (the “DSH Funds”) were matching funds disbursed by the Health Care Financing Administration of the United States Department of Health and Human Services to the states through their Medicaid agencies for the purpose of compensating hospitals, such as those operated by the University, that provided medical care and treatment to a disproportionate share of indigent patients in their respective areas.

Access to the DSH Funds for Alabama was made possible by the University of South Alabama Foundation Board, beginning in October 1989, when the Board of the Foundation approved the entry into the matching program. Over a one-year period, the Foundation made a monthly revolving contribution of \$2 million, which yielded approximately \$24 million in federal grant monies. The Board of Trustees of the University adopted a resolution in March 1990, authorizing the transfer of the DSH Funds to the Foundation to be held by it to preserve and ensure the continued viability of the University of South Alabama Hospitals (“University Hospitals”) and their overall mission.

Litigation relating to the transfer of the DSH Funds was settled in November 1993, when an agreement was reached among the Department of Examiners of Public Accounts of the State of Alabama, the Board of Trustees of the University, and the Board of Directors of the Foundation, which required that all Medicaid disproportionate share hospital funds received through September 30, 1994, be transferred to the Foundation and held irrevocably for the benefit, as determined by the Foundation, of the University Hospitals and clinics and the other programs of the University that benefit such hospitals and clinics. Further the agreement recognized the Foundation as the lawful holder and owner of the DSH Funds and that the investment and management of the DSH Funds were solely within the authority of the Foundation’s Board.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation—The accompanying combined financial statements include the DSH Funds and Knollwood Development, Inc., a wholly owned subsidiary of the Foundation and an affiliate originally funded by DSH Funds. All significant interfund transactions have been eliminated in combination.

Net Assets—In order to ensure observance of limitations and restrictions placed on the use of the resources available to the DSH Funds, the accounts of the DSH Funds are maintained on the accrual basis in accordance with the principles of “fund accounting”; thus, resources for various purposes are classified into funds that are in accordance with activities or objectives specified. Financial Accounting Standards Board (FASB) Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, requires classification of an organization’s net assets and its revenue, expenses, gains, and losses based on the existence or absence of donor-imposed restrictions, using three classifications: permanently restricted; temporarily restricted; and unrestricted. These three classifications are defined as follows:

- Permanently restricted net assets contain donor-imposed restrictions that stipulate that resources be maintained permanently, but permit the use or expenditure of part or all of the income derived from the donated assets for specified or unspecified purposes.
- Temporarily restricted net assets contain donor-imposed restrictions that permit the use or expenditure of the donated assets as specified and are satisfied either by the passage of time or by actions of the Foundation.
- Unrestricted net assets are not restricted by donors or the donor-imposed restrictions have expired.

Support—Contributions received and unconditional promises to give are measured at their fair values and are reported as increases in net assets at the date of receipt. Gifts of cash and other assets are reported as temporarily restricted support if they are received with donor stipulations that limit the use of the donated assets, or if they are designated as support for future periods. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the combined statements of activities and changes in net assets as net assets released from restrictions.

Cash Equivalents—Temporary cash investments with an original maturity date of three months or less when purchased are considered to be cash equivalents. The carrying amounts reported in the accompanying combined statements of financial position for cash and cash equivalents approximate their fair value.

Investments in Securities—Investments in equity securities are maintained and administered in a common pool by the Foundation. Amounts presented in these financial statements represent the DSH Funds proportionate share of the Foundation’s investments.

Investments in Commonfund—The Commonfund for Nonprofit Organizations (Commonfund) is a membership corporation that operates endowment funds for the exclusive benefit of institutions eligible for membership in the Commonfund. The Foundation holds investments in the Multi-Strategy Equity Fund and the International Equity Fund of the Commonfund. The objective of the Multi-Strategy Equity Fund is to offer an investment in a single fund to provide all of the strategy and manager diversification that an endowment would normally require for equity allocation. The fund is designed to add value over long periods of time, above the return of the U.S. equity market as measured by the S&P 500 index, and to reduce volatility in comparison to that of investing in the index. The investment objective of the International Equity Fund is to seek to diversify a U.S. equity portfolio with equity investments in companies domiciled abroad. The fund is designed to outperform its benchmark, the Morgan Stanley Capital International World ex-U.S. index, over a full market cycle.

The Foundation's units in the Multi-Strategy Equity Fund and the International Equity Fund are valued at their unit values as determined by Commonfund. Commonfund generally determines the unit values of each of its Funds by reference to the fair values of the underlying investments, the majority of which consists of exchange-traded equity securities. Further information about Commonfund's valuation procedures follows.

In the Multi-Strategy Equity Fund and the International Equity Fund, as managed by Commonfund, equity securities listed on securities exchanges are valued at the last sale price, except for those securities reported through the National Association of Securities Dealers Automated Quotation System ("NASDAQ"), for which the NASDAQ Official Closing Price is used. In the absence of either, the current bid price is used. Unlisted securities are valued at the current bid prices obtained from reputable brokers. Certain investments held by the funds may be traded by a market maker who may also be utilized to provide pricing information used to value such investments. Investments in units of other Funds within Commonfund (known as crossfund investments) are carried at the unit value of the crossfund investment.

In these Funds, investments in limited partnerships and other investment funds are valued at fair value, which is generally the latest net asset value made available by the fund manager or administrator prior to the valuation date. Other securities that are not readily marketable are also valued at fair value as deemed appropriate by management of Commonfund in consultation with the respective investment manager, with consideration given to the financial condition and operating results of the issuer, meaningful third-party transactions in the private market, and other factors deemed relevant. The amounts realized upon disposition of these investments may differ from the value reflected in the financial statements and the differences could be material.

Investment Income—Investment income or loss (including gains and losses on investments, interest, dividends, rents, royalties, and timber sales) is included in the accompanying combined statement of activities and changes in net assets as increases or decreases in unrestricted net assets, unless the income or loss is restricted by donor or law, in which case it is classified as temporarily or permanently restricted, as appropriate. Interfund interest is recorded at prevailing market rates on loans between funds to maintain the integrity of each fund's net assets.

Income Allocation—The DSH Funds participate in the New Investment Pool (the "Pool") as described in Note 4. Funds that participate in the Pool, including DSH Funds, receive a monthly allocation of income and loss experienced by the Pool. Allocations made by the Pool to its participants are based on the relative participation levels of investment in the Pool by each participating fund.

Income Tax Status—The Internal Revenue Service has determined that the Foundation is a tax-exempt organization under Internal Revenue Code Section 501(c)(3).

Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the combined financial statements and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates. The DSH Funds participate in the Foundation's New Investment Pool (see Note 4). The New Investment Pool consists of the Foundation's investment in marketable securities, valued by reference to quoted market prices, investments in Commonfund portfolios valued at unit values based on the fair values of the underlying investments, and timberland, mineral properties, and other real estate valued by

appraisals. Such assets are subject to fluctuation in value due to normal market volatility, and to estimation risk in the case of assets for which market values are not available. The values ultimately realized by the Foundation for all such assets may be different from the values reported and these fluctuations may impact the DSH Fund's financial statements.

Recent Accounting Pronouncement—In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FASB Statement No. 157 applies whenever other accounting standards require or permit assets or liabilities to be measured at fair value. Fair value under FASB Statement No. 157 is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between participants at the measurement date. The standard clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. Under the standard, fair value measurements would be separately disclosed by the level within the fair value hierarchy. The Foundation will be required to apply FASB Statement No. 157 in its financial statements for the year ended June 30, 2009, and is in the process of evaluating the impact of FASB Statement No. 157 on its financial statements.

3. FAIR VALUE OF FINANCIAL INSTRUMENTS AND OTHER INVESTMENTS

The following methods and assumptions were used by the Foundation in estimating the fair value of its investments:

- **Cash and Cash Equivalents:** The carrying amount reported in the accompanying combined statement of financial position for cash and cash equivalents approximates its fair value.
- **Equity Securities:** Includes investments in marketable securities and investments in Commonfund.
- **Marketable Equity Securities:** Fair values are based on quoted market prices of each security with readily determinable fair values.
- **Investments in Commonfund:** Fair values are based on unit values, as determined by Commonfund. As more fully described in Note 2, Commonfund determines unit values for each of its portfolios based on the fair values of the underlying assets.
- **Timber, mineral properties, and real estate:** Fair values of timberland, mineral properties, and real estate are determined by independent third-party appraisers using standard appraisal practices particular to the investment being appraised.
- **Other:** Consists primarily of the Foundation's interest in the Stallworth Land Company.

4. INVESTMENTS

Investments consisted of participation in the Foundation's pooled investment funds. On June 5, 2006, the Board of the Foundation approved the establishment of a new Investment Pool which consists of (1) all the Existing Pooled Equities held by the Foundation, and (2) the Foundation's interest in the land and timber consisting of approximately 55,600 acres of timberland known as the

Equitable Tract, which the Foundation acquired in 1997 with financing that was provided, in part, from the DSH Funds to the Foundation's Equitable Timber Fund. Effective June 30, 2006, upon establishment of the Pool, the interest in the Pool allocated to the DSH Funds is equal in value to the sum of (1) the value of the interest that was allocated to the DSH Funds in the Foundation's Existing Securities Pool at June 30, 2006, and (2) the amount of the aggregate receivable for principal and interest owed by the Equitable Timber Fund to the DSH at June 30, 2006. On June 30, 2008, the value of DSH units in the Pool was \$131,794 and at June 30, 2007, the value of DSH units in the Pool was \$140,903.

Investment income for the years ended June 30, 2008 and 2007, was comprised of the following:

	2008	2007
Unrealized (losses) gains	\$ (12,245)	\$ 10,369
Realized (losses) gains	(1,143)	1,594
Interest and dividends	1,074	2,005
Interfund interest	395	591
Rental income	10	
	<u>\$ (11,909)</u>	<u>\$ 14,559</u>

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

	2008	2007
Land and land improvements—held for investment	\$ 4,000	\$ 8,695
Building and building improvements—held for investment		1,132
	<u>\$ 4,000</u>	<u>\$ 9,827</u>

In the fiscal year ending June 30, 2008, the Foundation sold the former Wright Campus, consisting of approximately 32 acres, for \$5,400. The DSH Funds recognized a loss on the sale of real estate in the amount of \$319.

5. RELATED-PARTY TRANSACTIONS

At June 30, 2008 and 2007, receivables from affiliated entities totaled \$459 and \$3,716, respectively. These amounts are due to the DSH Funds from other entities owned by the Foundation. These receivables earn interest at a standard market rate, based on the applicable federal rates (rates used for federal tax purposes). Interest income was \$395 and \$591 for the years ended June 30, 2008 and 2007, respectively. As described in Note 4, effective June 30, 2006, the DSH Funds participate in the Pool of the Foundation and the DSH Funds earn a proportionate share of investment income of the Pool.

By resolution adopted August 5, 2004, the Foundation pledged a grant in the aggregate amount of Ten Million Five Hundred Thousand Dollars (\$10,500) to be given by it to the University for the USA Cancer Research Institute. The remaining pledge of \$2,000 is to be funded from the Foundation's Disproportionate Share Fund and is to be disbursed in installments over a period of either two or three years, subject to a determination, to be made by the Board of Directors of the Foundation prior to disbursement of each installment, that such disbursement can be paid without adversely affecting the financial condition of the Foundation. The installments paid during the years ended June 30, 2008 and 2007, totaled \$4,000 and \$1,500, respectively.

By a resolution adopted May 22, 2008, the Foundation approved a contribution to the University in support of the Pediatric Expansion of USA Children's and Women's Hospital in the amount of Twenty Million Dollars (\$20,000) to be given over a seven-year period, to begin in the year of the commencement of the expansion. This grant is to be disbursed from the Foundation's Disproportionate Share Hospital Funds. Further, to be effective the year following the initial contribution, the Board shall seek to distribute annually not less than 3% of the average fiscal year-end net assets of the DSH Funds, which may be disbursed in response to requests submitted by the University for support of the Pediatric Expansion or otherwise in support of the University's hospitals, clinics and related programs. All such disbursements shall be subject to a determination, to be made by the Board of Directors of the Foundation, prior to disbursement of each installment that such disbursement can be made without adversely affecting the financial condition of the Foundation. To date, the Pediatric Expansion has not been commenced, and therefore, no disbursement has been made.

6. NATURE AND AMOUNT OF TEMPORARILY RESTRICTED NET ASSETS

At June 30, 2008 and 2007, temporarily restricted net assets of \$6,172 and \$24,026, respectively, were available for the support of hospitals, clinics, and related programs of the University.

7. NATURE AND AMOUNT OF PERMANENTLY RESTRICTED NET ASSETS

At June 30, 2008 and 2007, permanently restricted net assets of \$131,586 and \$131,586, respectively, are restricted to investments in perpetuity, the income from which may be used for the support of hospitals, clinics, and related programs of the University.

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