

University of South Alabama
Quarterly Financial Statements
(A Component Unit of the State of Alabama)
Nine Months Ended June 30, 2012 and 2011

Unaudited

University of South Alabama
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University of South Alabama

Management's Discussion and Analysis

Introduction

The following discussion presents an overview of the financial position and financial activities of the University of South Alabama (the University). This discussion was prepared by University management and should be read in conjunction with the financial statements and notes thereto, which follow.

Financial Highlights

At June 30, 2012, the University had total assets of \$952,185,000, total liabilities of \$521,165,000 and net assets of \$431,020,000. University net assets increased \$14,124,000 for the nine months ended June 30, 2012 compared to an increase of \$824,000 for the nine months ended June 30, 2011. An overview of each statement is presented below along with a financial analysis of the transactions impacting the statement.

Condensed financial statements for the University at and for the nine months ended June 30, 2012 and 2011 follow (in thousands):

Condensed Statements of Net Assets

	2012	2011
<i>Assets</i>		
Current	\$ 313,998	\$ 317,499
Capital and other noncurrent assets	638,187	585,651
	<u>952,185</u>	<u>900,150</u>
<i>Liabilities</i>		
Current	118,634	110,117
Noncurrent	402,531	370,028
	<u>521,165</u>	<u>480,145</u>
<i>Net Assets</i>		
Invested in capital assets, net of related debt	209,145	195,373
Restricted, nonexpendable	32,963	32,161
Restricted, expendable	44,797	45,110
Unrestricted	144,115	147,461
	<u>\$ 431,020</u>	<u>\$ 420,005</u>

University of South Alabama

Management's Discussion and Analysis (continued)

Condensed Statements of Revenues, Expenses and Changes in Net Assets

	2012	2011
<i>Operating revenues</i>		
Tuition and fees	\$ 75,332	\$ 64,832
Hospital revenues, net	170,508	161,753
Other	<u>109,959</u>	<u>96,609</u>
	355,799	323,194
<i>Operating expenses</i>		
Salaries and benefits	300,048	289,943
Supplies and other services	105,209	111,676
Other	<u>38,138</u>	<u>36,492</u>
	<u>443,395</u>	<u>438,111</u>
Operating loss	(87,596)	(114,917)
<i>Nonoperating revenues (expenses)</i>		
State appropriations	79,244	72,712
State appropriated ARRA funds	-	8,864
Other, net	<u>7,912</u>	<u>15,062</u>
Net nonoperating revenues, net	<u>87,156</u>	<u>96,638</u>
Other revenues, expenses, gains or losses	<u>14,564</u>	<u>19,013</u>
Increase in net assets	14,124	724
Beginning net assets	<u>416,896</u>	<u>419,271</u>
Ending net assets	<u>\$ 431,020</u>	<u>\$ 420,005</u>

Analysis of Financial Position and Results of Operations

Statements of Net Assets

The statements of net assets present the assets, liabilities and net assets of the University as of the end of the current reporting period. 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 by an external donor. Unrestricted net assets, while they are generally designated for specific purposes, are available for use by the University to meet current expenses for any purposes. The statements of net assets, along with all of the University's basic financial statements, are prepared under the accrual basis of

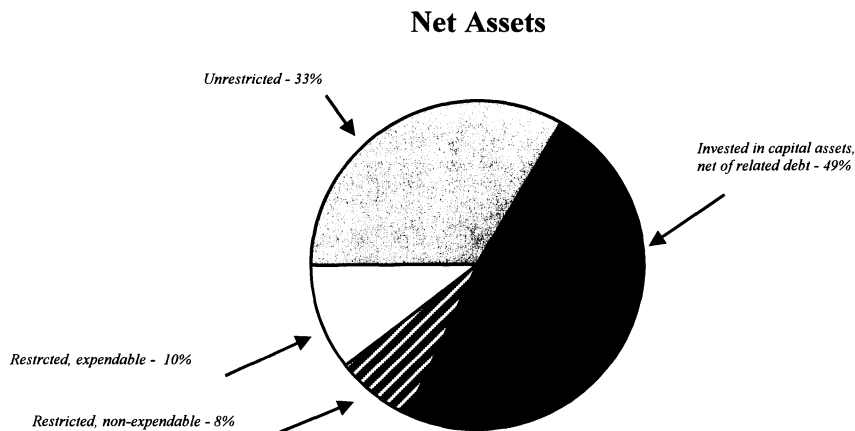
University of South Alabama

Management's Discussion and Analysis (continued)

accounting, whereby revenues are recognized when the service is provided and expenses are recognized when others provide the service to the University, regardless of when cash is exchanged.

Assets included in the statements of net assets are classified as current or noncurrent. Current assets consist primarily of cash and cash equivalents, operating investments and hospital patient accounts receivable. Current liabilities consist primarily of accounts payable and accrued liabilities.

Net assets represent the residual interest in the University's assets after liabilities are deducted and are classified into one of four categories as shown on the following illustration, as of the end of the current reporting period:



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

Restricted nonexpendable net assets consist primarily of the University's permanent endowment funds. The corpus of these funds may not be expended and must remain with the University in perpetuity. Only the earnings from these funds may be expended. 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.

University of South Alabama

Management's Discussion and Analysis (continued)

Although unrestricted net assets are not subject to externally imposed stipulations, substantially all of the University's unrestricted net assets have been designated for various academic and research programs and initiatives as well as capital projects.

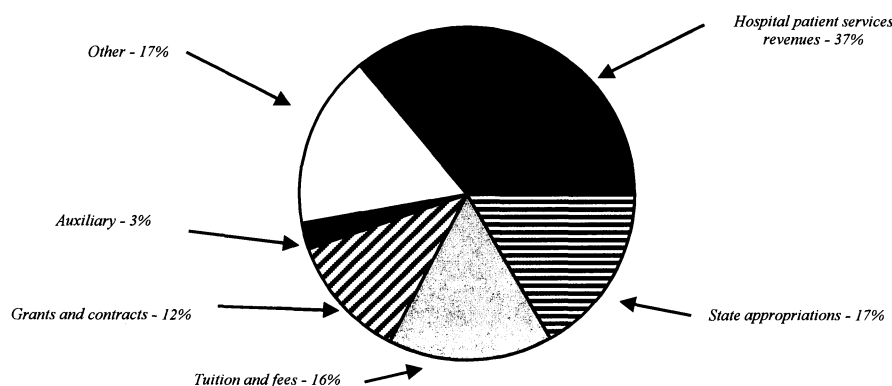
Statements of Revenues, Expenses and Changes in Net Assets

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

Generally, operating revenues are received for providing goods and services to the various customers and constituencies of the University. Operating expenses are those expenses paid 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 are revenues received for which goods and services are not provided. GASB Statement No. 34 requires that state appropriations be classified as nonoperating.

Approximately one-half of the operating revenues of the University are hospital patient care revenues. The remainder consists primarily of tuition and fees, grants and contracts and auxiliary enterprise revenues. The following illustration presents the major sources of University revenues (operating, nonoperating and other) for the current period:

Sources of Revenues

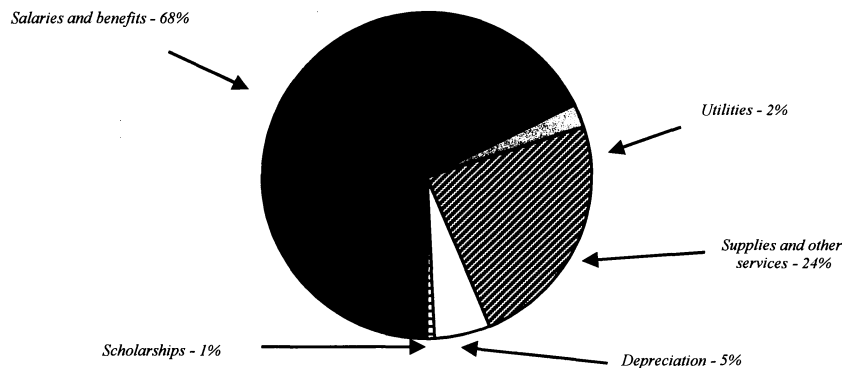


University of South Alabama

Management's Discussion and Analysis (continued)

University expenses are presented using natural expense classifications. Salaries and benefits represent the majority of the University's operating expenses. The following illustration presents the major University operating expenses, including the hospitals, using natural classification for the current period:

Operating Expenses by Natural Classification



Capital Assets and Debt Administration

During the current period, construction continued on Shelby Hall and the expansion of Children's and Women's Hospital and planning began on the new Delta student housing facility. Additionally, several other construction and renovation projects at the University and Hospitals remained ongoing during the current period. In fiscal 2010, the Football Field House and a major addition to the University's central utility plant system were placed into service. In fiscal 2011, the Student Recreation Center, Moulton Tower, the Glass Blowing Studio and the Student Dining Facility were placed into service. In fiscal 2012, Stokes Hall, the renovation of the University Bookstore and the campus entrance portals have been placed into service.

In June 2010, the University issued the University Facilities Revenue Capital Improvement Bond, Series 2010, with a face value of \$29,750,000. The net proceeds of this bond will be used to fund the construction of new student housing as well as other construction and capital improvement projects at the University.

In January 2012, the University issued the University Facilities Revenue Capital Improvement Bond, Series 2012-A, with a face value of \$25,000,000. The net proceeds

University of South Alabama

Management's Discussion and Analysis (continued)

of this bond will be used to fund the construction of new student housing as well as other construction and capital improvement projects at the University.

Also in January 2012, the University Facilities Revenue Capital Improvement Bond, Series 2012-B, with a face value of \$7,740,000. The net proceeds of this bond will be used to fund certain capital equipment purchases at the hospital and Mitchell Cancer Institute.

In June 2012, the University issued a note payable with a face value of approximately \$1,113,800 to Siemens Healthcare for the financing of certain computer equipment and software.

In March 2012, the University's bond credit rating was downgraded by Moody's Investors Services from Aa3 to A1. This represents the first change in the University's bond credit rating since it was upgraded from A1 to Aa3 in 2010. The University also has a rating of A+ from Standard and Poor's Ratings Services, which has not changed in 2012.

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. The fair value component of the refunding associated with the swaps is considered an investment derivative and, as such, the change in the fair value component is reflected as a component of investment income.

Economic Outlook

While enrollment and tuition have both increased in recent years, state appropriations prior to 2006 were relatively flat. However, in the 2008, 2007 and 2006 fiscal years, the University experienced increases of 16%, 19% and 17%, respectively. These increases were unusually high. For the 2009 fiscal year, the University's original state appropriation decreased 12.8% or approximately \$17,882,000. Additionally, in December 2008 the Governor of Alabama announced proration of 9%, or approximately \$10,967,000; and in July 2009, the Governor announced additional proration of 2%, or

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Management's Discussion and Analysis (continued)

approximately \$2,437,000. Therefore, the total decrease in the 2009 state appropriation was approximately \$31,286,000 to \$108,451,000, or 22.4% lower than in 2008.

A state appropriation in the amount of approximately \$108,133,000 was authorized for the year ended September 30, 2010. In September 2009, the Governor announced proration of 7.5%, or approximately \$8,264,000; and in September 2010, the Governor announced additional proration of 2%, or approximately \$2,162,000. Therefore, the total decrease from the original authorized 2010 state appropriation was approximately \$10,426,000 to \$97,860,000, or 9.6% lower than the original appropriation and 9.8% lower than the actual 2009 amounts received.

A state appropriation in the amount of \$99,947,000 was authorized for the year ended September 30, 2011. In February 2011, the Governor announced proration of 3%, or approximately \$2,999,000, to approximately \$96,948,000.

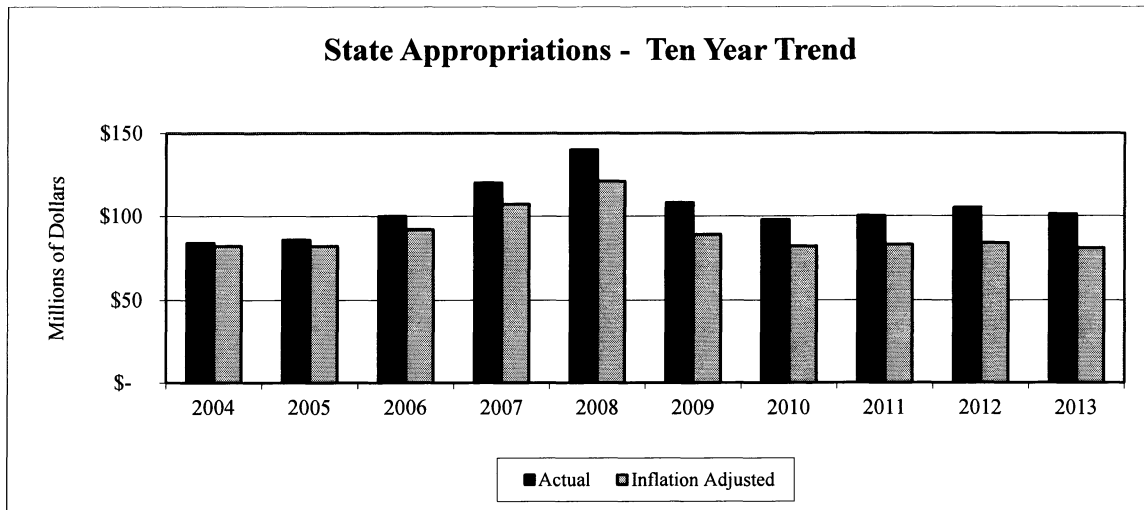
A state appropriation in the amount of approximately \$105,391,000 has been authorized and is being paid for the year ending September 30, 2012. This represents an \$8,443,000 increase from the fiscal 2011 appropriation received. While no announcement has been made, the University is aware that reductions in its 2012 appropriation are possible.

A state appropriation in the amount of approximately \$101,295,000 has been authorized for the year ending September 30, 2013. This represents a \$4,096,000 decrease from the fiscal 2012 appropriation.

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Management's Discussion and Analysis (continued)

State appropriations (actual and adjusted for inflation) for the last ten years are illustrated below:



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. 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 2012 beyond those unknown variables having a global effect on virtually all types of business operations.

University of South Alabama

Statements of Net Assets

June 30, 2012 and 2011

(In thousands)

	2012	2011
Assets		
Current assets		
Cash and cash equivalents	62,257	85,099
Investments	105,873	88,593
Net patient service receivables	36,775	35,697
Accounts receivable, affiliates	27,799	23,347
Accounts receivable, other	67,376	72,716
Notes receivable, net	4,558	4,236
Prepaid expenses, inventories and other	9,360	7,811
Total current assets	<u>313,998</u>	<u>317,499</u>
Noncurrent assets		
Restricted cash and cash equivalents	85,594	48,035
Investments, at fair value	-	19,320
Investments	790	826
Accounts receivable	4,368	5,705
Notes receivable, net	10,371	14,052
Other noncurrent assets	25,404	27,377
Capital assets (net of accumulated depreciation)	511,660	467,336
Total noncurrent assets	<u>638,187</u>	<u>582,651</u>
Total assets	<u>952,185</u>	<u>900,150</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	50,086	49,710
Deferred revenue	56,740	52,132
Deposits	2,192	1,603
Current portion of long-term debt	9,616	6,672
Total current liabilities	<u>118,634</u>	<u>110,117</u>
Noncurrent liabilities		
Long-term debt	352,869	327,748
Other long-term liabilities	49,662	42,280
Total noncurrent liabilities	<u>402,531</u>	<u>370,028</u>
Total liabilities	<u>521,165</u>	<u>480,145</u>
Net Assets		
Invested in capital assets, net of related debt	209,145	195,273
Restricted, nonexpendable		
Scholarships	14,517	13,813
Other	18,446	18,348
Restricted, expendable		
Scholarships	9,165	9,900
Other	35,632	35,210
Unrestricted	144,115	147,461
Total net assets	<u>431,020</u>	<u>420,005</u>

See accompanying notes.

University of South Alabama

Statements of Revenues, Expenses and Changes in Net Assets

Nine Months Ended June 30, 2012 and 2011

(In thousands)

	<u>2012</u>	<u>2011</u>
Revenues		
Operating revenues		
Tuition and fees (net of scholarship allowances)	75,332	64,832
Patient services and other (net of contractual allowances and bad debt expense)	170,508	161,753
Federal grants and contracts	14,366	15,488
State grants and contracts	3,856	4,545
Private grants and contracts	38,789	37,876
Auxiliary enterprises (net of scholarship allowances)	12,052	9,763
Other operating revenues	40,896	28,937
Total operating revenues	<u>355,799</u>	<u>323,194</u>
Expenses		
Operating expenses		
Salaries and benefits	300,048	289,943
Supplies and other services	105,209	111,676
Scholarships and fellowships	3,412	3,913
Utilities	10,485	10,507
Depreciation	24,241	22,072
Total operating expenses	<u>443,395</u>	<u>438,111</u>
Operating loss	<u>(87,596)</u>	<u>(114,917)</u>
Nonoperating revenues (expenses)		
State appropriations	79,244	72,712
State appropriated ARRA funds	-	8,864
Investment income and gains on investments	1,348	7,142
Interest on indebtedness	(10,308)	(10,848)
Other nonoperating revenues	22,067	22,119
Other nonoperating expenses	(5,195)	(3,351)
Net nonoperating revenues	<u>87,156</u>	<u>96,638</u>
Loss before other revenues, expenses, gains or losses	<u>(440)</u>	<u>(18,279)</u>
Capital appropriations	-	-
Capital gifts and grants	12,223	16,233
Additions to endowment	2,341	2,780
Increase in net assets	<u>14,124</u>	<u>734</u>
Net assets		
Beginning of period	<u>416,896</u>	<u>419,271</u>
End of period	<u><u>431,020</u></u>	<u><u>420,005</u></u>

See accompanying notes.

University of South Alabama

Statements of Cash Flows

Nine Months Ended June 30, 2012 and 2011

(in thousands)

	<u>2012</u>	<u>2011</u>
Cash flows from operating activities:		
Receipts related to tuition and fees	\$ 49,465	\$ 46,138
Receipts from and on behalf of patients and third-party payers	166,134	166,173
Receipts from grants and contracts	49,567	52,940
Receipts related to auxiliary enterprises	9,764	8,553
Payments to suppliers and vendors	(118,542)	(120,915)
Payments to employees and related benefits	(293,412)	(303,076)
Payments for scholarships and fellowships	(3,412)	(3,913)
Other operating receipts	54,755	35,036
Net cash used in operating activities	<u>(85,681)</u>	<u>(119,064)</u>
Cash flows from noncapital financing activities:		
State appropriations	61,096	57,446
State appropriated ARRA Funds	-	8,204
Endowment gifts	2,341	1,468
Agency funds received	634	521
Agency funds disbursed	(390)	(249)
Student loan program receipts	60,730	47,376
Student loan program disbursements	(60,980)	(47,099)
Other nonoperating revenues	17,652	21,684
Other nonoperating expenses	(5,510)	(3,351)
Net cash provided by noncapital financing activities	<u>75,573</u>	<u>86,000</u>
Cash flows from capital and related financing activities:		
Capital gifts and grants	14,234	16,233
Purchases of capital assets	(45,206)	(49,976)
Proceeds from sale of capital assets	3,846	3,942
Proceeds from issuance of capital debt	32,740	-
Principal payments on capital debt	(4,785)	(4,650)
Interest payments on capital debt	(9,217)	(9,350)
Net cash used in capital and related financing activities	<u>(8,388)</u>	<u>(43,801)</u>
Cash flows from investing activities:		
Interest and dividends on investments	2,589	3,290
Purchases of investments	(37,468)	(11,785)
Proceeds from sales of investments	23,463	20,021
Net cash provided by (used in) investing activities	<u>(11,416)</u>	<u>11,526</u>
Net decrease in cash and cash equivalents	(29,912)	(65,339)
Cash and cash equivalents (unrestricted and restricted):		
Beginning of year	<u>177,762</u>	<u>198,473</u>
End of year	<u>\$ 147,850</u>	<u>\$ 133,134</u>

See accompanying notes.

University of South Alabama

Statements of Cash Flows

Nine Months Ended June 30, 2012 and 2011

(in thousands)

	<u>2012</u>	<u>2011</u>
Reconciliation of operating loss to net cash used in operating activities:		
Operating loss	\$ (87,596)	\$ (114,917)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation and amortization expense	24,241	22,072
Changes in assets and liabilities, net:		
Student receivables	(35,438)	(30,795)
Net patient accounts receivable	(3,068)	(4,843)
Grants and contracts receivables	(4,526)	(4,625)
Other receivables	(3,633)	1,797
Prepaid expenses, inventories, and other	(1,584)	163
Accounts payable and accrued liabilities	3,575	(3,578)
Deferred revenue	22,348	15,662
Net cash used in operating activities	\$ <u>(85,681)</u>	\$ <u>(119,064)</u>

See accompanying notes.

University of South Alabama
Notes to Financial Statements
June 30, 2012

1. Summary of Significant Accounting Policies

Reporting Entity

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

The financial reporting entity, as defined by Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity* and amended by GASB Statement No. 39, *Determining Whether Certain Organizations Are 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, at year-end, the basic financial statements include the accounts of the University, as the primary government, and the accounts of the following entities as component units. For quarterly reporting purposes, however, component units are not presented in the University's basic financial statements.

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, 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 in its annual financial statements. For quarterly reporting purposes, discretely presented component unit financial statements are not presented.

The University is also affiliated with the South Alabama Medical Science Foundation. This entity is not considered a component unit of the University under the provisions of GASB Statement Nos. 14 and 39.

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, USAHSF, and USA HealthCare Management, LLC 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

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Notes to Financial Statements
June 30, 2012

which the University is responsible, as defined by GASB Statement No. 14. The PLTF and GLTF are separate legal entities which are governed by the University Board of Trustees through the University president. As such, PLTF and GLTF are reported as blended component units in its annual financial statements. For quarterly reporting purposes these entities are not blended into the University's statements.

USA HealthCare Management, LLC

In June 2010, the University's Board of Trustees approved the formation of USA HealthCare Management, LLC (the LLC). The University is the sole member of the LLC, which was organized for the purpose of managing and operating on behalf of and as agent for, substantially all of the health care enterprises of the University. The LLC is considered a blended component unit of the University, as defined by GASB Statement No. 14 and, as such, is reported as a blended component unit in its quarterly financial statements.

University of South Alabama Foundation

The USA Foundation is a not-for-profit corporation 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. The USA Foundation presents its financial statements in accordance with standards issued by the Financial Accounting Standards Board (FASB). The USA Foundation has a June 30 fiscal year end which differs from the University's September 30 fiscal year end.

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. The USAHSF presents its financial statements in accordance with standards issued by the FASB.

USA Research and Technology Corporation

The Corporation is a not-for-profit corporation that exists for the purpose of furthering the educational and scientific mission of the University by developing, attracting, and retaining technology and research industries in Alabama that will provide professional and career opportunities to the University's students and faculty. Because of the

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June 30, 2012

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 the GASB.

In September 2010, the Corporation caused the formation of NovALtech, LLC (NovALtech). NovALtech is a single-member limited liability company that exists for the purpose of engaging in scientific research and development activities and facilitating the transfer and utilization of technology, patents, processes, copyrights, formulae and other know-how. The activities of NovALtech are included in the financial statements of the Corporation.

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 the 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.

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.

Cash and Cash Equivalents

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

University of South Alabama
Notes to Financial Statements
June 30, 2012

Investments and Investment Income

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

Derivatives

In fiscal 2010, the University adopted the provisions of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB 53 establishes a framework for accounting and financial reporting related to derivative instruments, requiring the fair value of the derivatives to be recognized in the basic financial statements

The University has two interest rate swaptions which were entered into in January 2008. As a result of entering into the swaptions, the University received up-front payments. Swaptions are considered hybrid instruments which are required to be bifurcated into the fair value of the derivative and a piece that reflects a borrowing for financial statement purposes, which will accrete interest over time. The University determined that as of the current period, the swaptions were not hedging derivative instruments. Therefore, the swaptions are required to be recorded as investment derivatives, with the change in fair value flowing through the statements of revenues, expenses, and changes in net assets.

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.

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 basis) or market.

Capital Assets

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

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June 30, 2012

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.

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. are deferred and recognized as revenue over the term of the lease using the straight-line method.

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

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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.

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.

Donor Restricted Endowments

The University is subject to the "Uniform Prudent Management of Institutional Funds Act (UPMIFA)" 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 law also allows the University to appropriate for expenditure or accumulate to an endowment fund such amount as to University determines to be prudent for the purposes for which the endowment was established. 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.

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.

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

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.

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.

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.

State Appropriated ARRA Funds

Pursuant to the American Recovery and Reinvestment Act of 2009 the University was awarded approximately \$10,769,000 annually in 2010 and 2011 through the U. S. Department of Education's State Fiscal Stabilization Fund Program. These funds are billed and recorded as revenue as they are expended and reported in the Statement of Revenues, Expenses and Changes in Net Assets as State Appropriated ARRA Funds. Beginning October 1, 2011, funds are no longer being awarded pursuant to the provisions of this program.

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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.

Compensated Absences

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

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, 2011, the net public deposits subject to collateral requirements for all institutions participating in the pool totaled approximately \$8,134,635,000.

4. Investments

The investments of the University are invested pursuant to the University of South Alabama "Nonendowment Cash Pool Investment Policy," 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

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preserving principal. The University Investment Policies require that management apply the “prudent person” standard in the context of managing its investment portfolio.

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.

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.

Interest Rate Risk

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.

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 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 follow:

Issue	Date of Issue	Option Expiration Date	Effective Date of Swap	Termination Date	Payment Amount
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 \$41,245,000 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 cancelled and the University would have no further obligation under this agreement.

Financial statement presentation

A swaption is considered a hybrid instrument and as such the payment by the counterparty to the University must be bifurcated into two components, a borrowing component and an embedded derivative component, and each component treated separately. The embedded derivative value of the swaption represents the fair value resulting from the fact that the fixed rate stated in the swaption is greater than the at-the-market rate. The initial value of the borrowing is the difference between the upfront payment and the fair value of the embedded derivative and represents the time value to the counterparty for holding the option, or the probability weighted, discounted values of a range of future possible outcomes. The value of the derivative and borrowings at the date of execution of this transaction are as follows:

	2004 Bonds	2006 Bonds
Embedded derivatives	\$ 918,000	3,343,000
Borrowings	1,070,000	3,997,000
	<u>\$ 1,988,000</u>	<u>7,340,000</u>

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The values of the borrowings are included in long-term debt on the University's statements of net assets. Interest is being accreted, and added to the borrowings through the expiration date of the option.

The fair values of the embedded investment derivatives are reported as investment assets if the derivatives are assets or other noncurrent liabilities, depending of the fair values of the derivatives. The change in the fair market values of the derivatives is reported as a component of investment income in the statements of revenues, expenses and changes in net assets.

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 the current date, the swap counterparty was rated Aa3 by Moody's investors Services and AA by Standard and Poor's Rating Services.

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

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substantial amount of money to terminate the contracts. As of the current date, no events of termination have occurred.

6. Bonds Payable

Bonds payable consisted of the following at the end of the current period:

University Tuition Revenue Bonds, Series 1999 Capital Appreciation, 4.7% to 5.25%, payable November 2011 through November 2018

University Tuition Revenue Refunding and Capital Improvement Bonds, Series 2004, 2.00% to 5.00%, payable through March 2024

University Tuition Revenue Refunding and Capital Improvement bonds, Series 2006, 5.00%, payable through June 2037

University Facilities Revenue Capital Improvement Bonds, Series 2008, 3.00% to 5.00%, payable through August 2038.

University Facilities Revenue Capital Improvement Bond, Series 2010, 3.81%, payable through August 2030.

University Facilities Revenue Capital Improvement Bond, Series 2012-A, 2.92%, payable through August 2032.

University Facilities Revenue Capital Improvement bond, Series 2012-B, 2.14%, payable through February 2018.

Borrowing arising from swaption, Series 2004 Bonds

Borrowing arising from swaption, Series 2006 Bonds

Substantially all student tuition and fee revenues secure University bonds. Additionally, security for Series 2008 bonds include Children's and Women's Hospital revenues in amounts not exceeding \$10,000,000. Series 1999 Current Interest Bonds began maturing November 2002, and Series 1999 Capital Appreciation Bonds began maturing 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 began maturing in August 2009 and are redeemable beginning September 2018. Series 2010 bonds began maturing in August 2011 and are redeemable beginning in February 2020.

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,

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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 enter into swap arrangements with respect to its Series 2004 and 2006 bonds at their respective redemption dates. See footnote five for a complete description of this transaction.

The University defeased certain indebtedness during 1978 and 1984 by depositing funds in escrow trust accounts sufficient to provide for the subsequent payment of principal and interest on the defeased indebtedness. Neither the assets of the escrow trust accounts nor the defeased indebtedness is included in the accompanying statements of net assets.

The University is subject to restrictive covenants related to certain note and bonds payable. As of the end of the current period, management believes the University was in compliance with such financial covenants.

7. 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 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 and settled through 2008. The Medical Center cost report has, however, been reopened related to disproportionate share issues affecting all PPS acute care hospitals nation-wide. The cost report for USA Children's and Women's Hospital has been audited and settled through 2009. Revenue from the Medicare program accounted for approximately 14% and 13% of the Hospitals' net patient service revenue for the year ended June 30, 2012 and 2011, 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

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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 Hospital's Blue Cross cost reports have been audited through 2010 and settled for all fiscal years through 2009. Revenue from the Blue Cross program accounted for approximately 17% and 18% of the Hospitals' net patient service revenue for the years ended June 30, 2012 and 2011, 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 25% and 29% of the Hospital's net patient service revenue for the years ended June 30, 2012 and 2011.

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.

8. Hospital Lease

The University and Infirmity Health System, Inc. (the Infirmity) have 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 Infirmity. 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 Infirmity 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 Infirmity, 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 Infirmity, 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 Infirmity to be significant, as defined by the lease. University management does not anticipate that this option will be exercised by the Infirmity.

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In January 2009, the Infirmary and the University entered into a "First Amendment to Lease Agreement" (the Amendment). The Amendment deferred the original payment terms of the lease for two years such that during the period from January 2009 to December 2010, annual lease payments are reduced to \$1 annually. Beginning in January 2011, the original payment schedule resumed. The payment schedule and narrative presented below reflect these revised terms.

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 Infirmary. In addition to the prepayment, required lease payments by the Infirmary to the University are as follows (payable monthly):

- Months one through thirty-three of the initial lease term - \$1,000,000 annually (\$83,333 monthly)
- Months thirty-four through fifty-seven of the initial lease term - \$1 annually
- Months fifty-eight through eighty-four of the initial lease term - \$1,000,000 annually (\$83,333 monthly)
- Years eight through twelve of the initial lease term - \$1,250,000 annually
- Years thirteen through seventeen of the initial lease term - \$1,500,000 annually
- Years eighteen through thirty-two 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-three 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 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.

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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 2013 at a fixed rate of 3.75%.

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 \$43,788,000. 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 \$6,327,000, will be deferred and amortized over the ninety-nine year lease term.

9. Employee Benefits

Retirement and Pension Plans

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

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

All employees covered by this retirement plan must contribute 7.25% of their eligible earnings to TRS. An actuary employed by the TRS Board of Control establishes the employer-matching amount annually.

The defined contribution pension plan covers certain academic and administrative employees employed prior to October 1, 2009, and participation by eligible employees is optional. Under this plan, administered by Teachers Insurance and Annuity Association –

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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.

Employees of the LLC may, at their option, participate in a defined contribution plan. Under this plan, eligible employees may make contributions to the plan which are matched, dollar-for-dollar, by the LLC up to 5% of compensation.

Compensated Absences

Regular University employees accumulate vacation and sick leave and hospital and clinical employees accumulate paid time off. These are 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 and paid time off at their regular rate of pay up to a maximum of two times their annual accumulation rate. No accrual is recognized for sick leave benefits since no terminal cash benefit is available to employees for accumulated sick leave.

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 has been 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.

10. Risk Management

The University, USAHSF and the LLC participate in the professional liability trust fund and the University and the LLC 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, USAHSF and the LLC, 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, USAHSF and the LLC in proportion to contributions made.

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.

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The University and HCM participate in a self-insured health plan, administered by an unaffiliated entity. Contributions by the University and the LLC and their 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.

11. Other Related Party

The South Alabama Medical Science Foundation (SAMSF) is a not-for-profit corporation that exists for the purpose of promoting education and research at the University. SAMSF reimburses the University for certain administrative expenses and other related support services.

12. Commitments and Contingencies

Grants and Contracts

The University had been awarded certain amounts 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.

Letter of Credit

In connection with the Hospitals' participation in the State of Alabama Medicaid Program, the University has established a \$77,000 irrevocable standby letter of credit with Wells Fargo Bank. The Alabama Medicaid Agency is the beneficiary of this letter of credit. No funds are currently advanced under this letter.

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.

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Rent Supplement Agreement

The University has entered into two irrevocable rent supplement agreements with the Corporation and a financial institution. These agreements require 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. As of the end of the current period, no amounts were payable pursuant to these agreements.

State Bond Issue

The State of Alabama has made allocations to the University from bonds issued in prior years. Pursuant to the allocations, funds are available to the University for certain future construction costs. The allocations have not been reflected in the accompanying financial statement.

FICA Refund

In March 2010, the Internal Revenue Service (the Service) ruled that for all tax periods ending before April 2005, the medical residents and fellows working at the USA hospitals could be treated under the student exception with respect to FICA taxes. Historically, the Service had held that residents and fellows were not exempt for FICA taxes. As a result of this ruling, the University has recorded a receivable of \$5,213,000 representing the employer's portion of FICA contributions from March 1996 to April 2005 and any related interest.

13. Significant New Accounting Pronouncements

In February 2009, the GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definition*. GASB Statement No. 54 revised classification requirements related to fund balance reporting and was effective for the year ended September 30, 2011. The adoption of Statement No. 54 did not have a material impact on the University's basic financial statements.

In December 2009, the GASB issued Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. GASB Statement No. 57 addresses issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multi-employer other post-employment benefits plans and will be effective for the year ending September 30, 2012. In November 2010, the GASB issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*. GASB Statement No. 60 addresses accounting and reporting issues related to public-public and public-private service concession arrangements and will be effective for the year ending September 30, 2012. In November 2010, the GASB issued Statement No. 61, *The Financial Reporting Entity*:

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Notes to Financial Statements
June 30, 2012

Omnibus. GASB Statement No. 61 modifies certain requirements for inclusion of component units in the financial reporting entity and will be effective for the year ending September 30, 2013. In December 2010, the GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. GASB Statement No. 62 incorporates into the GASB's authoritative literature accounting and financial reporting guidance that is included in certain FASB and AICPA authoritative literature, where such guidance does not conflict with or contradict GASB pronouncements. In June 2011, the GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position*. Statement No. 63 renames the Statement of Net Assets as the Statement of Net Position and requires that deferred inflows and outflows of resources be reported as components of the Statement of Net Position and will be effective for the year ending September 30, 2013. In June 2011, the GASB issued Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions*. GASB Statement No. 64 clarifies whether an effective hedging relationship continues after the replacement of a swap counterparty or a swap counterparty's credit support provider and will be effective for the year ending September 30, 2012. In March 2012, the GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*. GASB Statement No. 65 establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities and will be effective for the year ending September 30, 2014. In March 2012, the GASB issued Statement No. 66, *Technical Corrections – 2012*. GASB Statement No. 66 resolves conflicting guidance that resulted from the issuance of GASB Statements No. 54 and 62 and will be effective for the year ending September 30, 2014.

The effect of the implementation of GASB Statements Nos. 57, 60, 61, 62, 63, 64, 65 and 66 on the University has not been determined.