

PENNS^TATE



Audited Financial Statements

The Pennsylvania State University
Fiscal Year Ended June 30, 2001

THE PENNSYLVANIA STATE UNIVERSITY

UNIVERSITY OFFICERS

as of October 5, 2001

GRAHAM B. SPANIER
President of the University

RODNEY A. ERICKSON
Executive Vice President and
Provost of the University

WILLIAM W. ASBURY
Vice President for Student Affairs

JANIS E. JACOBS
Vice President for Administration

DARRELL G. KIRCH
Chief Executive Officer, The Milton S.
Hershey Medical Center, and Senior
Vice President for Health Affairs and
Dean, College of Medicine

RODNEY P. KIRSCH
Vice President for Development
and Alumni Relations

STEPHEN J. MAC CARTHY
Vice President for University
Relations

EVA J. PELL
Vice President for Research and
Dean of the Graduate School

JAMES H. RYAN
Vice President for Outreach
and Cooperative Extension

GARY C. SCHULTZ
Senior Vice President for
Finance and Business/Treasurer

Audited Financial Statements

The Pennsylvania State University
Fiscal Year Ended June 30, 2001

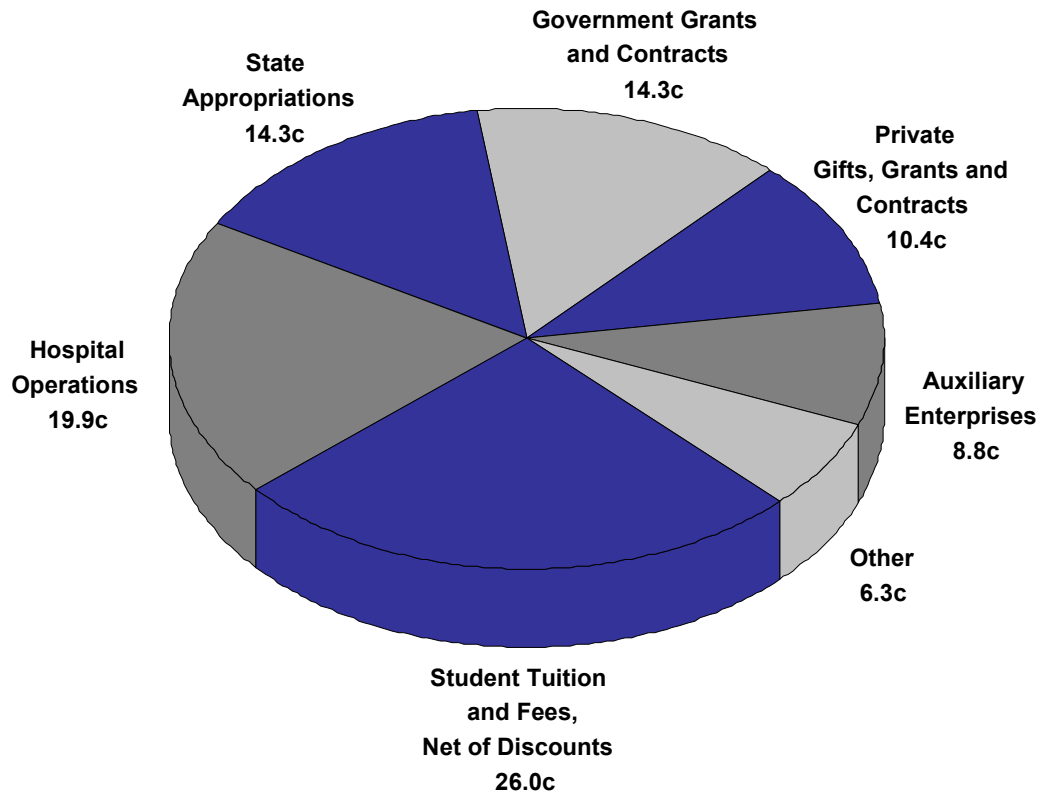
University Park, Pennsylvania

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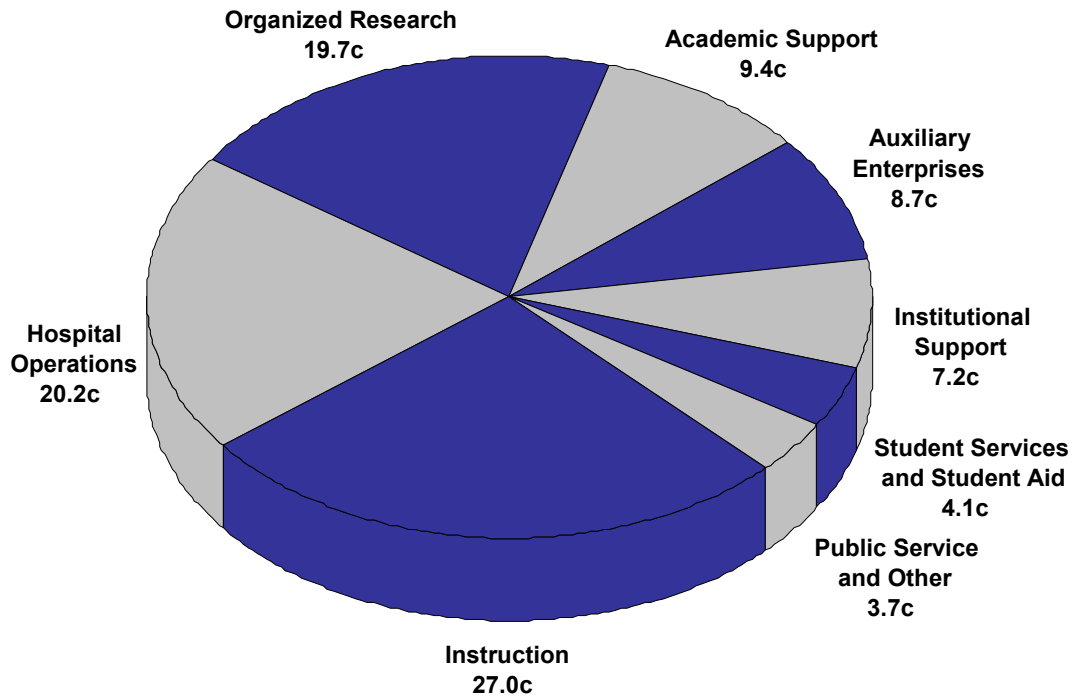
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UNIVERSITY DOLLAR

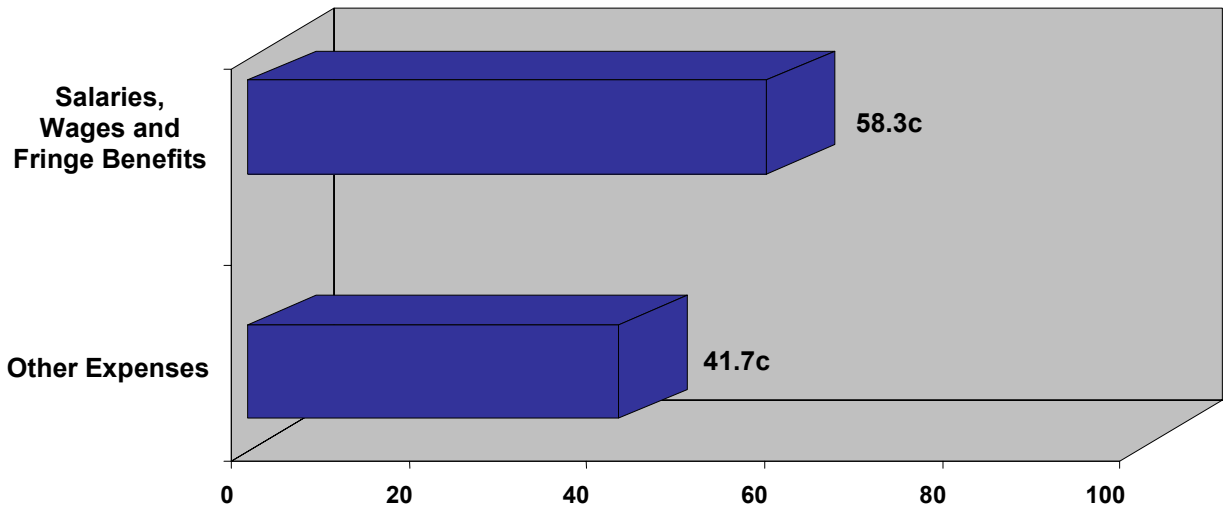
SOURCE



APPLICATION



APPLICATION BY OBJECT





Kenneth S. Babe
Corporate Controller

The Pennsylvania State University
408 Old Main
University Park, PA 16802-1505

(814) 865-1355

October 5, 2001

Dr. Graham Spanier, President
The Pennsylvania State University

Dear Dr. Spanier:


The Audited Consolidated Financial Statements of the University for the fiscal year ended June 30, 2001 are presented on the accompanying pages. These represent a complete and permanent record of the finances of the University for that year.

These financial statements have been examined by Deloitte & Touche LLP, Certified Public Accountants of Philadelphia, Pennsylvania, and their report has been made a part of this record.

Respectfully submitted,



Kenneth S. Babe
Corporate Controller



Gary C. Schultz
Senior Vice President for Finance and Business/Treasurer

Deloitte & Touche LLP
Twenty-Second Floor
1700 Market Street
Philadelphia, Pennsylvania 19103-3984

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INDEPENDENT AUDITORS' REPORT

To the Board of Trustees of
The Pennsylvania State University:

We have audited the accompanying consolidated statements of financial position of The Pennsylvania State University (the "University") as of June 30, 2001 and 2000, and the related statements of activities and of cash flows for the years then ended. These financial statements are the responsibility of the University'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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements referred to above present fairly, in all material respects, the consolidated financial position of the University at June 30, 2001 and 2000, and the consolidated changes in its net assets and its consolidated cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte + Touche LLP

October 5, 2001

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
ASSETS
JUNE 30, 2001 AND 2000
(in thousands)

	<u>June 30, 2001</u>	<u>June 30, 2000</u>
Current assets:		
Cash and cash equivalents - in short-term operating portfolios	\$ 154,221	\$ 118,240
Cash and cash equivalents - in operating investment portfolios	16,783	32,147
Deposits	16,290	15,266
Deposits held by bond trustees	23,686	5,665
Accounts receivable, net of allowances of \$26,402 and \$26,065	296,124	241,725
Contributions receivable, net	35,347	23,361
Loans to students, net of allowances of \$3,345 and \$2,958	8,273	8,113
Inventories	17,492	16,339
Prepaid expenses and other assets	<u>25,562</u>	<u>15,460</u>
Total current assets	<u>593,778</u>	<u>476,316</u>
Noncurrent assets:		
Deposits held by bond trustees	11,385	11,865
Accounts receivable	1,200	2,000
Contributions receivable, net	92,797	102,106
Loans to students, net of allowances of \$12,287 and \$11,197	30,401	30,790
Deferred bond costs	12,041	11,295
Total investment in plant, net of accumulated depreciation	1,653,892	1,580,137
Beneficial interest in perpetual trusts	11,846	12,392
Investments	<u>1,810,046</u>	<u>1,778,524</u>
Total noncurrent assets	<u>3,623,608</u>	<u>3,529,109</u>
Total assets	<u>\$ 4,217,386</u>	<u>\$ 4,005,425</u>

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
LIABILITIES AND NET ASSETS
JUNE 30, 2001 AND 2000
(in thousands)

	<u>June 30, 2001</u>	<u>June 30, 2000</u>
Current liabilities:		
Accounts payable and other accrued expenses	\$ 255,104	\$ 199,615
Deferred revenue	123,947	125,278
Long-term debt	35,675	34,866
Present value of annuities payable	3,938	3,488
Accrued postretirement benefits	<u>17,096</u>	<u>15,361</u>
Total current liabilities	<u>435,760</u>	<u>378,608</u>
Noncurrent liabilities:		
Deposits held in custody for others	14,418	14,684
Deferred revenue	927	945
Long-term debt	582,944	501,883
Present value of annuities payable	28,295	23,093
Accrued postretirement benefits	402,550	376,854
Refundable United States Government student loans	34,297	33,954
Other liabilities	<u>12,134</u>	<u>6,295</u>
Total noncurrent liabilities	<u>1,075,565</u>	<u>957,708</u>
Total liabilities	<u>1,511,325</u>	<u>1,336,316</u>
Net assets:		
Unrestricted-		
Undesignated	249	247
Designated for specific purposes	490,135	439,051
Funds functioning as endowment	334,444	365,070
Net investment in plant	<u>1,046,853</u>	<u>1,032,453</u>
Total unrestricted	<u>1,871,681</u>	<u>1,836,821</u>
Temporarily restricted	313,126	363,327
Permanently restricted	<u>521,254</u>	<u>468,961</u>
Total net assets	<u>2,706,061</u>	<u>2,669,109</u>
Total liabilities and net assets	<u>\$ 4,217,386</u>	<u>\$ 4,005,425</u>

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2001
(in thousands)

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Revenues and other support:				
Tuition and fees, net of discounts of \$57,092	\$ 600,968	\$ -	\$ -	\$ 600,968
Commonwealth of Pennsylvania -				
Appropriations	331,949	-	-	331,949
Special contracts	45,456	-	-	45,456
Department of General Services projects	16,547	-	-	16,547
United States Government grants and contracts	261,836	-	6,000	267,836
Private gifts, grants and contracts	153,303	38,614	47,653	239,570
Endowment income, net	(1,270)	(62,559)	7,783	(56,046)
Other investment income	71,023	3,525	107	74,655
Sales and services of educational activities	33,038	-	-	33,038
Recovery of indirect costs	71,835	-	-	71,835
Auxiliary enterprises	203,866	-	-	203,866
Hospital operations	460,376	-	-	460,376
Other sources	21,567	1,753	(546)	22,774
Net assets released from restrictions	<u>30,812</u>	<u>(30,812)</u>	<u>-</u>	<u>-</u>
Total revenues and other support	<u>2,301,306</u>	<u>(49,479)</u>	<u>60,997</u>	<u>2,312,824</u>
Expenses and losses:				
Educational and general -				
Instruction	613,758	-	-	613,758
Research	448,544	-	-	448,544
Public service	63,656	-	-	63,656
Academic support	214,023	-	-	214,023
Student services	91,692	-	-	91,692
Institutional support	164,511	-	-	164,511
Student aid	<u>1,945</u>	<u>-</u>	<u>-</u>	<u>1,945</u>
Total educational and general	<u>1,598,129</u>	<u>-</u>	<u>-</u>	<u>1,598,129</u>
Auxiliary enterprises	197,937	-	-	197,937
Hospital operations	458,796	-	-	458,796
Write-offs and disposals of assets	9,950	-	-	9,950
Other related entity expenses	1,634	-	-	1,634
Actuarial adjustment on annuities payable	<u>-</u>	<u>722</u>	<u>8,704</u>	<u>9,426</u>
Total expenses and losses	<u>2,266,446</u>	<u>722</u>	<u>8,704</u>	<u>2,275,872</u>
Increase/(decrease) in net assets	34,860	(50,201)	52,293	36,952
Net assets at the beginning of the year	<u>1,836,821</u>	<u>363,327</u>	<u>468,961</u>	<u>2,669,109</u>
Net assets at the end of the year	<u>\$ 1,871,681</u>	<u>\$ 313,126</u>	<u>\$ 521,254</u>	<u>\$ 2,706,061</u>

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2000
(in thousands)

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Revenues and other support:				
Tuition and fees, net of discounts of \$53,698	\$ 554,382	\$ -	\$ -	\$ 554,382
Commonwealth of Pennsylvania -				
Appropriations	314,134	-	-	314,134
Special contracts	41,668	-	-	41,668
Department of General Services projects	49,310	-	-	49,310
United States Government grants and contracts	237,807	-	-	237,807
Private gifts, grants and contracts	141,440	24,820	67,662	233,922
Endowment income, net	76,252	70,103	5,660	152,015
Other investment income	24,911	3,130	207	28,248
Sales and services of educational activities	79,265	-	-	79,265
Recovery of indirect costs	67,231	-	-	67,231
Auxiliary enterprises	196,746	-	-	196,746
Other sources	11,468	920	4,208	16,596
Net assets released from restrictions	<u>39,377</u>	<u>(39,377)</u>	<u>-</u>	<u>-</u>
Total revenues and other support	<u>1,833,991</u>	<u>59,596</u>	<u>77,737</u>	<u>1,971,324</u>
Expenses and losses:				
Educational and general -				
Instruction	570,733	-	-	570,733
Research	406,034	-	-	406,034
Public service	63,618	-	-	63,618
Academic support	205,655	-	-	205,655
Student services	85,464	-	-	85,464
Institutional support	151,311	-	-	151,311
Student aid	<u>1,593</u>	<u>-</u>	<u>-</u>	<u>1,593</u>
Total educational and general	<u>1,484,408</u>	<u>-</u>	<u>-</u>	<u>1,484,408</u>
Auxiliary enterprises	188,908	-	-	188,908
Write-offs and disposals of assets	29,867	-	28,106	57,973
Other related entity expenses	1,690	-	-	1,690
Actuarial adjustment on annuities payable	<u>-</u>	<u>707</u>	<u>6,443</u>	<u>7,150</u>
Total expenses and losses	<u>1,704,873</u>	<u>707</u>	<u>34,549</u>	<u>1,740,129</u>
Increase in net assets	129,118	58,889	43,188	231,195
 Net assets at the beginning of the year	 <u>1,707,703</u>	 <u>304,438</u>	 <u>425,773</u>	 <u>2,437,914</u>
 Net assets at the end of the year	 <u>\$ 1,836,821</u>	 <u>\$ 363,327</u>	 <u>\$ 468,961</u>	 <u>\$ 2,669,109</u>

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2001 AND 2000
(in thousands)

	<u>June 30, 2001</u>	<u>June 30, 2000</u>
Cash flows from operating activities:		
Increase in net assets	\$ 36,952	\$ 231,195
Adjustments to reconcile change in net assets to net cash provided by operating activities-		
Actuarial adjustment on annuities payable	9,426	7,150
Contributions restricted for long-term investment	(78,665)	(92,531)
Interest and dividends restricted for long-term investment	(16,712)	(6,084)
Net realized and unrealized losses/(gains) on long-term investments	56,747	(94,872)
Depreciation and amortization expense	159,966	98,824
Write-offs and disposals of assets	9,950	57,973
Contributions of land, buildings and equipment	(4,584)	(10,228)
Buildings and equipment provided by Pennsylvania Department of General Services	(16,547)	(49,310)
Contribution to government student loan funds	556	167
Provision for/(recoveries of) bad debt	14,129	(14,525)
Increase in deposits	(1,024)	(2,378)
(Increase)/decrease in receivables	(40,019)	60,121
(Increase)/decrease in inventories	(1,153)	485
Increase in prepaid expenses and other assets	(14,428)	(3,801)
Increase in accounts payable and other accrued expenses	45,649	21,381
(Decrease)/increase in deferred revenue	(1,348)	14,513
Increase in accrued postretirement benefits	27,432	24,708
Net cash provided by operating activities	<u>186,327</u>	<u>242,788</u>
Cash flows from investing activities:		
Purchase of land, buildings and equipment	(222,028)	(211,518)
Purchase of Penn State Geisinger Health System net assets	-	(171,952)
(Increase)/decrease in deposits held by bond trustees	(17,541)	14,982
Advances on student loans	(9,859)	(10,633)
Collections on student loans	8,063	7,972
Purchase of investments	(1,267,705)	(974,559)
Proceeds from sale of investments	1,170,580	1,060,821
Net cash used by investing activities	<u>(338,490)</u>	<u>(284,887)</u>
Cash flows from financing activities:		
Contributions restricted for long-term investment	78,665	92,531
Interest and dividends restricted for long-term investment	16,712	6,084
Payments of annuity obligations	(3,587)	(2,937)
Proceeds from issuance of bonds	114,370	-
Principal payments on notes, bonds and capital leases	(33,204)	(23,275)
Bond issuance costs and discounts	(1,397)	-
Proceeds related to government student loan funds, net of collection costs	1,221	1,278
Net cash provided by financing activities	<u>172,780</u>	<u>73,681</u>
Net increase in cash and cash equivalents	20,617	31,582
Cash and cash equivalents at the beginning of the year	<u>150,387</u>	<u>118,805</u>
Cash and cash equivalents at the end of the year	<u>\$ 171,004</u>	<u>\$ 150,387</u>

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED JUNE 30, 2001 AND 2000

1. THE UNIVERSITY AND RELATED ENTITIES

The University, which was created as an instrumentality of the Commonwealth of Pennsylvania, is organized as a non-profit corporation under the laws of the Commonwealth. As Pennsylvania's land grant university, the University is committed to improving the lives of the people of Pennsylvania, the nation and the world through its integrated, tri-part mission of high-quality teaching, research and outreach.

The financial statements of the University include, on a consolidated basis, the financial statements of The Milton S. Hershey Medical Center ("TMSHMC"), a not-for-profit corporation, (see Note 11 for additional information about TMSHMC) and The Corporation for Penn State and its subsidiaries ("the Corporation"). The Corporation is a non-profit member corporation organized in 1985 for the exclusive purpose of benefiting and promoting the interests of the University, the Corporation's sole member. The Corporation's assets and revenues consist primarily of the assets and revenues of The Pennsylvania College of Technology ("Penn College"), a wholly-owned subsidiary of the Corporation. All material transactions between the University, TMSHMC and the Corporation have been eliminated.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies followed by the University, as summarized below, are in accordance with the recommendations for accounting and reporting included in the Audit and Accounting Guide for Not-for-Profit Organizations issued by the American Institute of Certified Public Accountants. In addition, the University has utilized the descriptions and classifications of revenues and expenses as set forth in Section 500 of the Financial Accounting and Reporting Manual for Higher Education published by the National Association of College and University Business Officers.

Adoption of Financial Accounting Standards Board ("FASB") No. 133

Effective July 1, 2000, the University adopted Statement of Financial Accounting Standards ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as "derivatives"), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. The impact of adopting SFAS No. 133 was not material to the University's financial statements.

Basis of Presentation

The University's financial statements include statements of financial position, statements of activities and statements of cash flows. Net assets and the changes in net assets are classified as permanently restricted, temporarily restricted or unrestricted.

Permanently restricted net assets consist primarily of the historical amounts of endowed gifts. Additionally, contributions receivable and remainder interests, which are required by donors to be permanently retained, are included at their estimated present values.

Temporarily restricted net assets consist primarily of contributions receivable and accumulated endowment gains which can be expended, but for which restrictions have not yet been met. Such restrictions include time restrictions imposed by donors or implied by the nature of the gift or by interpretations of law.

Unrestricted net assets are all the remaining net assets of the University.

As permitted, donor-restricted gifts that are received and either spent or deemed spent within the same year are reported as unrestricted revenue. Gifts of long-lived assets are reported as unrestricted revenue. Gifts specified for the acquisition or construction of long-lived assets are reported as unrestricted net assets when the assets are placed in service.

The University maintains various funds and accounts, including endowments, funds functioning as endowment, departmental funds and related accumulated gains, in accordance with the principles of "fund accounting." This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds that are in accordance with specified activities or objectives. Separate accounts are maintained for each fund. Gifts are recorded in funds and investment income is distributed to funds annually. Income distributed to funds may be a combination of capital appreciation and yield pursuant to the University's total return investment policy.

Basis of Accounting

The financial statements of the University have been prepared on the accrual basis of accounting.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts on the financial statements and the disclosure of contingencies and commitments. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The University has provided fair value estimates for certain financial instruments in the notes to the financial statements. Fair value information presented in the financial statements is based on information available at June 30, 2001 and 2000. The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and long-term debt - current portion are reasonable estimates of their fair value. The carrying values of the amounts of the University's loans to students are also reasonable estimates of their fair value, because approximately 99% of the total outstanding loans to students as of June 30, 2001 and 2000 have been made at the rates available to students for similar loans at such times. The fair value of investments is disclosed at Note 3. The fair value of the University's bonds payable is disclosed at Note 6.

Hospital Operations

TMSHMC has agreements with third-party payors that provide for payments to TMSHMC at amounts different from its established rates. Payment arrangements include prospectively-determined rates per discharge, reimbursed costs, discounted charges and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in the future periods as final settlements are determined.

TMSHMC has agreements with various Health Maintenance Organizations (HMO's) to provide medical services to subscribing participants. Under these agreements, TMSHMC receives monthly capitation payments based on the number of each HMO's participants, regardless of services actually performed by TMSHMC. In addition, the HMO's make fee-for-service payments to TMSHMC for certain covered services based upon discounted fee schedules.

TMSHMC provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates.

Cash Flows

The following items are included as supplemental disclosure to the statements of cash flows for the years ended June 30:

	<u>2001</u>	<u>2000</u>
Interest paid	\$ 32,387,000	\$ 28,178,000
Non-cash acquisitions of land, buildings and equipment	21,131,000	59,538,000

The University defines cash and cash equivalents based on the primary purpose of the investment portfolio that holds the investment and not the specific maturity of the asset. Accordingly, there may be assets with maturities greater than 90 days that are included in cash and cash equivalents if the overall purpose of the related investment portfolio is for short-term operating needs. Similarly, there are assets with maturities of less than 90 days included in certain pooled investment portfolios for endowment and funds functioning as endowment.

Additionally, due to the investment strategies of portfolio managers, there is \$16,783,000 and \$32,147,000 of cash and cash equivalents held in operating investment portfolios at June 30, 2001 and 2000, respectively. These assets have been separately identified as cash and cash equivalents in the statements of financial position.

Inventories

Inventories are stated at cost, generally on the first-in, first-out basis, which is lower than market.

Investments

The University's investments are reported at fair market value in the accompanying financial statements. Investments in equity securities with readily determinable fair values and all investments in debt securities are reported at fair values with gains and losses included in a statement of activities.

The estimated fair value amounts for marketable debt and equity securities held by the University have been determined using available market information as supplied by the various financial institutions that act as trustees or custodians for the University. For non-liquid holdings, generally investments in real estate, venture capital and energy limited partnerships, estimated fair value is determined based upon financial information provided by the limited partnerships.

Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the consolidated financial statements.

Beneficial Interest in Perpetual Trusts

The University receives endowment income from investments of \$11,846,000 and \$12,392,000 held by outside trustees at June 30, 2001 and 2000, respectively. The present value of expected future cash flows to the University from such investments has been recorded as permanently restricted net assets and related beneficial interest in perpetual trusts in the financial statements.

Investment in Plant

Fixed assets, including collections, are stated at cost or fair market value at date of gift. Depreciation is computed over the estimated economic lives of the assets using the straight-line method. Total investment in plant as of June 30 is comprised of the following:

	<u>2001</u>	<u>2000</u>
Land	\$ 67,473,000	\$ 64,119,000
Buildings	1,981,873,000	1,819,484,000
Improvements other than buildings	256,435,000	249,388,000
Equipment	<u>596,420,000</u>	<u>584,381,000</u>
Total plant	2,902,201,000	2,717,372,000
Less accumulated depreciation	<u>(1,248,309,000)</u>	<u>(1,137,235,000)</u>
Total investment in plant	<u>\$ 1,653,892,000</u>	<u>\$ 1,580,137,000</u>

During the year ended June 30, 2001, the University changed the estimated useful lives for many of its buildings and their related components, such as foundations and roof covers. Depreciation expense was \$45,774,000 higher for the year ended June 30, 2001 than it otherwise would have been had this change not been made. This amount included \$35,805,000 for buildings and components that are now considered fully depreciated under the new lives.

Reclassification

Certain comparative amounts for 2000 have been reclassified to conform to the 2001 presentation.

3. INVESTMENTS

Investments by major category as of June 30 are summarized as follows:

	<u>2001</u>	<u>2000</u>
Money markets	\$ 19,961,000	\$ 67,230,000
Fixed income:		
U.S. government/agency	435,029,000	405,089,000
U.S. corporate	379,130,000	244,183,000
Foreign	49,926,000	115,721,000
Common stock	606,674,000	632,043,000
Other investments	<u>336,109,000</u>	<u>346,405,000</u>
Total	<u>\$1,826,829,000</u>	<u>\$ 1,810,671,000</u>

Common stock investments are comprised of domestic and foreign equities. Other investments consist primarily of interests in real estate, venture capital and energy limited partnerships.

The following schedule summarizes the investment return and its classification in the statement of activities for the year ended June 30, 2001:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Dividends and interest	\$ 65,275,000	\$ 3,251,000	\$ 7,798,000	\$ 76,324,000
Net realized gains	48,206,000	18,533,000	92,000	66,831,000
Net unrealized losses	<u>(43,728,000)</u>	<u>(80,818,000)</u>	-	<u>(124,546,000)</u>
Total returns	<u>\$ 69,753,000</u>	<u>\$(59,034,000)</u>	<u>\$ 7,890,000</u>	<u>\$ 18,609,000</u>

The following schedule summarizes the investment return and its classification in the statement of activities for the year ended June 30, 2000:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Dividends and interest	\$ 75,978,000	\$ 3,476,000	\$ 5,685,000	\$ 85,139,000
Net realized gains	19,710,000	6,362,000	182,000	26,254,000
Net unrealized gains	<u>5,475,000</u>	<u>63,395,000</u>	-	<u>68,870,000</u>
Total returns	<u>\$ 101,163,000</u>	<u>\$ 73,233,000</u>	<u>\$ 5,867,000</u>	<u>\$ 180,263,000</u>

4. POOLED ASSETS

The University uses a "total return" approach to endowment fund investment management. This approach emphasizes total investment return (current income plus or minus realized and unrealized capital gains and losses) as the basis for endowment spending. The University has implemented an endowment income spending policy whereby a predetermined amount is paid out each fiscal year based upon a prescribed formula in accordance with Pennsylvania statutes.

Investments aggregating \$903,740,000 and \$947,532,000 at June 30, 2001 and 2000, respectively, for certain endowment funds and funds functioning as endowments are pooled on a market value basis, with each individual fund subscribing to or disposing of units on the basis of the market value per unit at the beginning of the month when the transaction takes place.

The following schedule summarizes certain information about pooled assets on a per unit basis:

	<u>June 30, 2001</u>	<u>June 30, 2000</u>
Market value per unit	\$ 27.20	\$ 29.72
Annual net gains/(losses) per unit	\$ (2.52)	\$ 3.00
Average annual earnings per unit, exclusive of gains/(losses)	\$.64	\$.72

5. CONTRIBUTIONS RECEIVABLE

Unconditional contributions receivable are recognized when received and consist of written or oral promises to contribute to the University in the future. Contributions receivable are recorded after discounting to the present value of the future cash flows. Contributions receivable in the amount of \$128,144,000 and \$125,467,000 are recorded with the revenue assigned to the appropriate category of restriction as of June 30, 2001 and 2000, respectively.

Contributions receivable as of June 30 are expected to be realized as follows:

	<u>2001</u>	<u>2000</u>
In one year or less	\$ 43,202,000	\$ 30,024,000
Between one year and five years	77,237,000	89,680,000
More than five years	<u>59,793,000</u>	<u>59,972,000</u>
	180,232,000	179,676,000
Less allowance	(8,074,000)	(7,281,000)
Less discount	<u>(44,014,000)</u>	<u>(46,928,000)</u>
Contributions receivable, net	<u>\$ 128,144,000</u>	<u>\$ 125,467,000</u>

The University has conditional contributions receivable of \$1,493,000 and \$1,268,000 as of June 30, 2001 and 2000, respectively.

6. BONDS PAYABLE

The various bond issues that are included in long-term debt in the statements of financial position follow:

- \$75,000,000 of general obligation bonds issued in April 2001 for the purpose of funding various construction projects. The bonds are currently paying interest on a variable rate basis; however, the University has the option to convert to a fixed rate basis. The bonds currently pay interest at 2.7% with adjustment on a weekly basis to the rate that the remarketing agent believes will cause the bonds to have a market value equal to the principal amount up to a maximum of 12%. The bondholders have the right to tender bonds at interest rate reset dates. The University, therefore, entered into a standby bond purchase agreement with a bank to provide liquidity in case of tender. The principal amount of the bonds is due April 2031. The bonds are not subject to sinking fund redemption; however, the University has the option to redeem the bonds prior to their scheduled maturity.
- \$108,700,000 (Series A - \$96,290,000; Series B - \$12,410,000) of general obligation bonds issued in December 1997 for the purpose of funding various construction projects and for refunding the Series 1992B Bonds. The proceeds of the 1997B Series were irrevocably placed into a trust with PNC Bank, N.A. as Trustee. Utilizing the proceeds, the Trustee purchased direct obligations of the U. S. Government which will mature at such times and in such amounts so that the principal and interest earned will be sufficient to pay maturing principal and interest and to redeem the remaining outstanding Series 1992B Bonds in August 2002. Principal payments are due annually, in amounts ranging from \$2,255,000 to \$4,750,000 through August 2019, with additional payments of \$14,110,000 due August 2022 and \$28,775,000 due August 2027. The bonds pay interest at rates ranging from 4.5% to 5.25% and are subject to sinking fund redemption beginning August 2020 and early redemption provisions, at the option of the University, beginning August 2007.
- \$35,010,000 of general obligation bonds issued in March 1993 (Refunding Series 1993A) for the purpose of refunding the Series 1993A Bonds (such bonds were previously issued to refund the Series 1992A Bonds). Principal payments are due annually, in amounts ranging from \$1,350,000 to \$1,635,000 through March 2006, with additional payments of \$3,530,000 due March 2008 and \$24,040,000 due March 2018. The bonds pay interest at rates ranging from 4.7% to 5.25% and are subject to sinking fund redemption beginning March 2007 and early redemption provisions, at the option of the University, beginning March 2003.
- \$207,470,000 (Series A - \$195,605,000; Series B - \$11,865,000) of general obligation bonds issued in August 1992 for the purpose of refunding the Second Refunding 1988 Series, 1989 Series and 1991 Series Bonds (Second Refunding 1992A Series) and to finance various construction projects (1992B Series). The proceeds of the Second Refunding Series of 1992A were irrevocably placed into a trust with Mellon Bank, N.A. as Trustee. Utilizing the proceeds, the Trustee purchased noncallable direct obligations of the U. S. Government which will mature at such time and in such amount so that the principal and the interest earned will be sufficient to pay maturing principal and interest and to redeem the remaining outstanding 1991 Series Bonds on July 1, 2001. Principal payments are due annually, in amounts ranging from \$10,810,000 to \$15,605,000 through August 2008, with an additional payment of \$103,195,000 due August 2016. The bonds pay interest at rates ranging from 5.10% to 5.60% and are subject to sinking fund redemption beginning August 2009 and early redemption provisions, at the option of the University, beginning August 2002. The \$11,865,000 of 1992 Series B Bonds was advance refunded by the Series 1997B Bonds. In prior years, the University defeased debt refunded by the Second Refunding Series 1992A as described above. Accordingly, the assets and liabilities for the defeased debt are not included in the University's financial statements. At June 30, 2001, \$48,215,000 of debt outstanding is considered defeased from the 1991 Series Bonds.
- \$71,255,000 of general obligation bonds issued in February 1992 for the purpose of refunding the 1986 Series and the First Refunding Series of 1988 Bonds. Principal payments are due annually in amounts ranging from \$5,385,000 to \$6,800,000 through March 2006, with an additional payment of \$40,925,000 due March 2011. The bonds pay interest at rates ranging from 5.85% to 6.25% and are subject to sinking fund redemption beginning March 2007 and early redemption provisions, at the option of the University, beginning March 2002. In May 2001, the University entered into a forward purchase agreement to enable it to advance refund the 1992 Bonds. In connection with the forward purchase agreement, the University recognized a liability in its statements related to the reoffering premium for the Refunding Series 2001 Bonds which have to be issued in December 2001 under the terms of the agreement.

- \$39,370,000 of Lycoming County Authority College Revenue Bonds issued by Penn College in December 2000 for the purpose of funding various construction projects, refunding the 1996 Lycoming County Authority College Revenue Bonds and advance refunding \$4,235,000 of the 1997 Lycoming County Authority College Revenue Bonds. The proceeds applied to the partial advanced refunding of the 1997 Series were deposited with the Trustee to be used to purchase U.S. Treasury obligations that upon maturity will provide principal and interest sufficient to pay the principal of and interest on the Refunded 1997 Bonds maturing on July 1 of the years 2006, 2007, 2008, and 2018. On July 1, 2007, the 2008 and 2018 bonds will also be redeemed at 101 percent of the principal amount to be redeemed. Principal payments are due annually, beginning in 2005, in amounts ranging from \$65,000 to \$5,225,000 through July 2030. The bonds pay interest at rates ranging from 4.75% to 5.375%.
- \$12,000,000 of Lycoming County Authority College Revenue Bonds issued by Penn College in September 1997 for the purpose of funding various construction projects at the Penn College campus. Principal payments are due annually, beginning in 2001, in amounts ranging from \$50,000 to \$5,010,000 through July 2018. The bonds pay interest at rates ranging from 3.95% to 5.25%.
- \$26,559,000 of Lycoming County Authority College Revenue Bonds issued by Penn College in 1993 for the purpose of undertaking a series of capital improvement projects and refunding \$20,305,000 of the Series 1990 Bonds. Principal payments are due annually in amounts ranging from \$450,000 to \$3,300,000 through November 2015. The bonds pay interest at rates ranging from 5.00% to 6.00%.

Maturities and sinking fund requirements on bonds payable for each of the next five fiscal years are summarized as follows:

<u>Year</u>	<u>Annual Installments</u>
2002	\$ 22,130,000
2003	23,320,000
2004	24,595,000
2005	25,950,000
2006	27,315,000

The fair value of the University's bonds payable is estimated based on current rates offered for similar issues with similar security, terms and maturities using available market information as supplied by the various financial institutions who act as trustees or custodians for the University. At June 30, 2001, the carrying value and estimated fair value of the University's bonds payable are \$575,364,000 and \$588,257,000, respectively. At June 30, 2000, the carrying value and estimated fair value of the University's bonds payable were \$495,282,000 and \$493,526,000, respectively.

7. NOTES PAYABLE

The various outstanding notes that are included in long-term debt in the statements of financial position follow:

- \$15,206,000 mortgage note payable by a subsidiary of the Corporation currently bearing interest at 10% with adjustment to the lender's prime interest rate plus ½% every two years (maturing October 2019).
- \$10,000,000 demand note payable bearing interest at variable rates (4.20% at June 30, 2001).

8. LEASES

The University has certain lease agreements in effect which are considered capital leases that are included as long-term debt in the statements of financial position. These leases have been capitalized at the net present value of the minimum lease payments. The University has recorded fixed assets in the amount of \$25,779,000 and \$25,717,000 at June 30, 2001 and 2000, respectively, representing capitalized leases. Future minimum lease

payments under capital leases together with the present value of the net minimum lease payments as of June 30, 2001 are as follows:

<u>Year</u>	
2002	\$ 3,245,000
2003	2,395,000
2004	1,903,000
2005	1,611,000
2006	1,488,000
Thereafter	<u>18,390,000</u>
Total minimum lease payments	29,032,000
Less imputed interest	<u>(10,983,000)</u>
Present value of net minimum lease payments	\$ <u>18,049,000</u>

The University has entered into a Master Building Sublease with ADG - Hospital Drive Associates ("ADG-HDA"), a limited partnership (of which the University maintains a 75% interest, carried at \$970,000 and \$1,011,000 in investments at June 30, 2001 and 2000, respectively), which required ADG-HDA to construct the Centre Medical Sciences Building ("Building") and lease it to the University for an initial term of twenty-five years. The Building was constructed on land jointly owned by the University and Centre Community Hospital ("Hospital"), which has been leased by ADG-HDA for a term of sixty years. The University has subleased portions of the Building to the Hospital and other healthcare related entities. The University is required to pay an annual base rent equal to the sum of (1) the principal, interest and redemption price due on the Centre County Higher Education Authority Bonds which were issued to finance the construction of the Building, and (2) an 8% return on the landlord's equity which is included above as a capitalized lease.

The University has certain lease agreements in effect which are considered operating leases. During the year ended June 30, 2001, the University recorded expenses of \$5,139,000 for leased equipment and \$7,929,000 for leased building space. During the year ended June 30, 2000, the University recorded expenses of \$3,369,000 for leased equipment and \$6,621,000 for leased building space.

Future lease payments under operating leases as of June 30, 2001 are as follows:

<u>Year</u>	
2002	\$ 3,159,000
2003	2,827,000
2004	2,407,000
2005	2,137,000
2006	1,852,000
Thereafter	<u>3,883,000</u>
Total minimum lease payments	\$ <u>16,265,000</u>

9. RETIREMENT BENEFITS

The University provides retirement benefits for substantially all regular employees, primarily through either contributory defined benefit plans administered by the Commonwealth of Pennsylvania State Employees' Retirement System and The Public School Employees' Retirement System or defined contribution plans administered by the Teachers Insurance and Annuity Association – College Retirement Equity Fund and Fidelity Investments. The University is billed for its share of the estimated actuarial cost of the defined benefit plans (\$1,930,000 and \$10,399,000 for the years ended June 30, 2001 and 2000, respectively). The University's total

cost for retirement benefits, included in expenses, is \$56,250,000 and \$50,239,000 for the years ended June 30, 2001 and 2000, respectively.

10. POSTRETIREMENT BENEFITS

The University sponsors a retiree medical plan covering eligible retirees and eligible dependents. This plan includes hospital, surgical, major medical coverage and Medicare Risk HMO's and provides a Medicare Supplement for individuals over age 65. In addition, the University provides retiree life insurance benefits of either \$5,000 at the time of death at no cost to the employee or additional coverage for eligible employees up to a maximum of \$10,000, provided the individual makes the required contributions.

Retirees are eligible for medical coverage and life insurance at age 60 if they have at least 15 years of regular full-time employment and participation in a University-sponsored medical plan (for those hired prior to August 1, 1984, ten years is required), or at an earlier age if they have at least 25 years of service and ten years of continuous participation in a University-sponsored medical plan immediately preceding the retirement date.

The retiree medical and life plans are generally self-funded programs, except for Medicare Risk HMO's, and all medical claims, death benefits and other expenses are paid from the unrestricted net assets of the University. The retirees contribute varying amounts for coverage under the medical plan. As of January 1, 2001, the monthly rates ranged from \$6 to \$198 depending on age and dependent coverage options selected. Life insurance contributions are \$13.50 semi-annually.

The following sets forth the plan's benefit obligation, plan assets and funded status reconciled with the amounts recognized in the University's consolidated statements of financial position at June 30:

Change in benefit obligation:

	<u>2001</u>	<u>2000</u>
Benefit obligation at beginning of year	\$ 368,210,000	\$ 308,516,000
Service cost	15,453,000	13,758,000
Interest cost	29,029,000	26,249,000
Actuarial loss	30,993,000	35,067,000
Benefits paid	<u>(17,119,000)</u>	<u>(15,380,000)</u>
Benefit obligation at end of year	\$ <u>426,566,000</u>	\$ <u>368,210,000</u>

Change in plan assets:

	<u>2001</u>	<u>2000</u>
Fair value of plan assets at beginning of year	\$ -	\$ -
Employer contributions	17,119,000	15,380,000
Benefits paid	<u>(17,119,000)</u>	<u>(15,380,000)</u>
Fair value of plan assets at end of year	\$ <u>-</u>	\$ <u>-</u>
Funded status	\$ (426,566,000)	\$(368,210,000)
Unrecognized prior service cost	460,000	-
Unrecognized net actuarial loss/(gain)	<u>6,460,000</u>	<u>(24,005,000)</u>
Accrued postretirement benefit expense	\$ <u>(419,646,000)</u>	\$ <u>(392,215,000)</u>

Net periodic postretirement cost includes the following components for the years ended June 30:

	<u>2001</u>	<u>2000</u>
Service cost	\$ 15,453,000	\$ 13,758,000
Interest cost	29,029,000	26,249,000
Amortization of prior service cost	21,000	-
Amortization of unrecognized net gain	<u>48,000</u>	<u>81,000</u>
Net periodic postretirement cost	\$ <u>44,551,000</u>	\$ <u>40,088,000</u>

The assumed healthcare cost trend rate used in measuring the accumulated postretirement benefit obligation was 9.00% and 9.50% for the 2000-2001 and 1999-2000 plan years, respectively, reduced by 0.50% per year to a fixed level of 6.00%. The weighted average postretirement benefit obligation discount rate was 7.50% and 7.75% for the years ended June 30, 2001 and 2000, respectively.

If the healthcare cost trend rate assumptions were increased by 1% in each year, the accumulated postretirement benefit obligation would be increased by \$71,091,000 and \$59,085,000 as of June 30, 2001 and 2000, respectively. The effect of this change on the sum of the service cost and interest cost components of the net periodic postretirement benefit cost would be an increase of \$8,658,000 and \$7,801,000 as of June 30, 2001 and 2000, respectively. If the healthcare cost trend rate assumptions were decreased by 1% in each year, the accumulated postretirement benefit obligation would be decreased by \$56,885,000 and \$47,565,000 as of June 30, 2001 and 2000, respectively. The effect of this change on the sum of the service cost and interest cost components of the net periodic postretirement benefit cost would be a decrease of \$6,781,000 and \$6,108,000 as of June 30, 2001 and 2000, respectively.

Gains and losses in excess of 10% of the accumulated postretirement benefit obligation are amortized over the average future service to assumed retirement of active participants.

11. THE MILTON S. HERSHEY MEDICAL CENTER

On November 18, 1999, the Board of Directors of the Penn State Geisinger Health System ("PSG Health System") voted to restructure the relationship between the University and the former Geisinger Health System to begin the process of unwinding the 1997 merger that created the PSG Health System. This process was completed on June 30, 2000, and included, among other things, the transfer of the clinical enterprise of the Hershey Medical Center complex (the University Hospitals and the University Physicians Faculty Practice Plan) to the University and the transfer of the Weis Center for Research to Geisinger.

The University created a new subsidiary, TMSHMC, in which the University has a controlling interest and to which it transferred assets of the clinical enterprise effective July 1, 2000. The University retains ownership of the Hershey Medical Center complex, including all buildings and land occupied by the University Hospital at June 30, 2000, and continues to operate the College of Medicine. The clinical facilities of the Hershey Medical Center complex are leased to TMSHMC and TMSHMC makes certain payments to support the College of Medicine.

As part of these agreements, on June 30, 2000, the University purchased an offsite ambulatory care facility, patient accounts receivable, certain moveable equipment, and certain inventory from PSG Health System for approximately \$172,000,000 (subject to potential post-closing adjustments). In addition, the PSG Health System transferred cash to cover the liability for accrued employee paid-time-off assumed by TMSHMC in the amount of \$9,640,000. The University also transferred the future interest in the Weis Research Center endowments valued at \$28,106,000 as of June 30, 2000 and expensed \$18,230,000 of other costs associated with the demerger. Third-party liabilities and medical malpractice claims (see also Note 12) incurred from November 1, 1999 through June 30, 2000 remain obligations of the University. After June 30, 2000, these liabilities and claims are recognized by TMSHMC.

Hospital operations expense includes academic support payments in support of medical education of \$25,021,000 for the year ended June 30, 2001.

12. CONTINGENCIES AND COMMITMENTS

Contractual Obligations

The University has contractual obligations for the construction of new buildings and for additions to existing buildings in the amount of \$266,137,000 of which \$201,510,000 has been paid or accrued as of June 30, 2001. The contract costs are being financed from available resources and from borrowings.

Under the terms of certain limited partnership agreements, the University is obligated to periodically advance additional funding for private equity and real estate investments. The University has unfunded commitments of approximately \$156,000,000 as of June 30, 2001 for which capital calls have not been exercised. Such commitments generally have fixed expiration dates or other termination clauses. The University maintains sufficient liquidity in its investment portfolio in the event that such calls are exercised.

Letters of Credit

The University has outstanding letters of credit in the amount of \$4,575,000 and \$4,937,000 as of June 30, 2001 and 2000, respectively. These letters of credit are used primarily to comply with minimum state and federal regulatory laws that govern various University activities. The fair value of these letters of credit approximates contract values based on the nature of the fee arrangements with the issuing banks.

Self-Insurance

The University has a coordinated program of commercial and self-insurance for medical malpractice claims at TMSHMC through the use of a domestic captive insurance company in combination with a self-insured retention layer and is supplementing this program through participation in the Pennsylvania Healthcare Services Malpractice Act (Act No. 111 of 1975), which provides limited insurance coverage. An estimate of the present value, discounted at 6%, of the medical malpractice claims liability in the amount of \$11,983,000 and \$5,100,000 is recorded as of June 30, 2001 and 2000, respectively.

With approval from the Pennsylvania Department of Labor and Industry ("PA-DLI"), the University elected to self-insure potential obligations applicable to workers' compensation. Certain claims under the program are contractually administered by a private agency. The University purchased reinsurance coverage for excess obligations over \$500,000 per incident and \$7,471,000 in the aggregate. An estimate of the self-insured workers' compensation claims liability in the amount of \$3,537,000 and \$5,639,000 is recorded as of June 30, 2001 and 2000, respectively. The University has established a trust fund, in the amount of \$6,383,000 and \$5,977,000 at June 30, 2001 and June 30, 2000, respectively, as required by PA-DLI, to provide for the payment of claims under this self-insurance program.

Litigation and Contingencies

Various legal proceedings have arisen in the course of conducting University business. The outcome of such litigation is not expected to have a material effect on the financial position of the University.

Based on its operation of the University Hospital (see Note 11), the University, like the healthcare industry, is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations can be subject to government review and interpretation, as well as regulatory actions. Recently, government reviews of healthcare providers for compliance with regulations have increased. Although the University believes it has done its best to comply with these numerous regulations, such government reviews could result in significant repayments of previously billed and collected revenues from patient services.

The Department of Health and Human Services, Office of the Inspector General (OIG) is conducting several nationwide reviews of Medicare billing practices, specifically performing audits of Medicare Part B billings by physicians at teaching hospitals (the PATH initiative). The University is subject to one of the OIG's PATH audits related to the University's prior operation of the University Hospital (see Note 11). The scope of the OIG audit covers the period July 1, 1995 to June 30, 1996. University management believes that any liabilities arising from such audits will not have a material effect on the University's financial statements.

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