PENNSTATE

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Audited Financial Statements

The Pennsylvania State University
Fiscal Year Ended June 30, 2008

THE PENNSYLVANIA STATE UNIVERSITY

UNIVERSITY OFFICERS

as of September 30, 2008

GRAHAM B. SPANIER
President of the University

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

RODNEY P. KIRSCH
Senior Vice President for Development
and Alumni Relations

HAROLD L. PAZ
Chief Executive Officer, The Milton S.
Hershey Medical Center, and Senior
Vice President for Health Affairs, and
Dean of the College of Medicine

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

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

THE PENNSYLVANIA STATE UNIVERSITY

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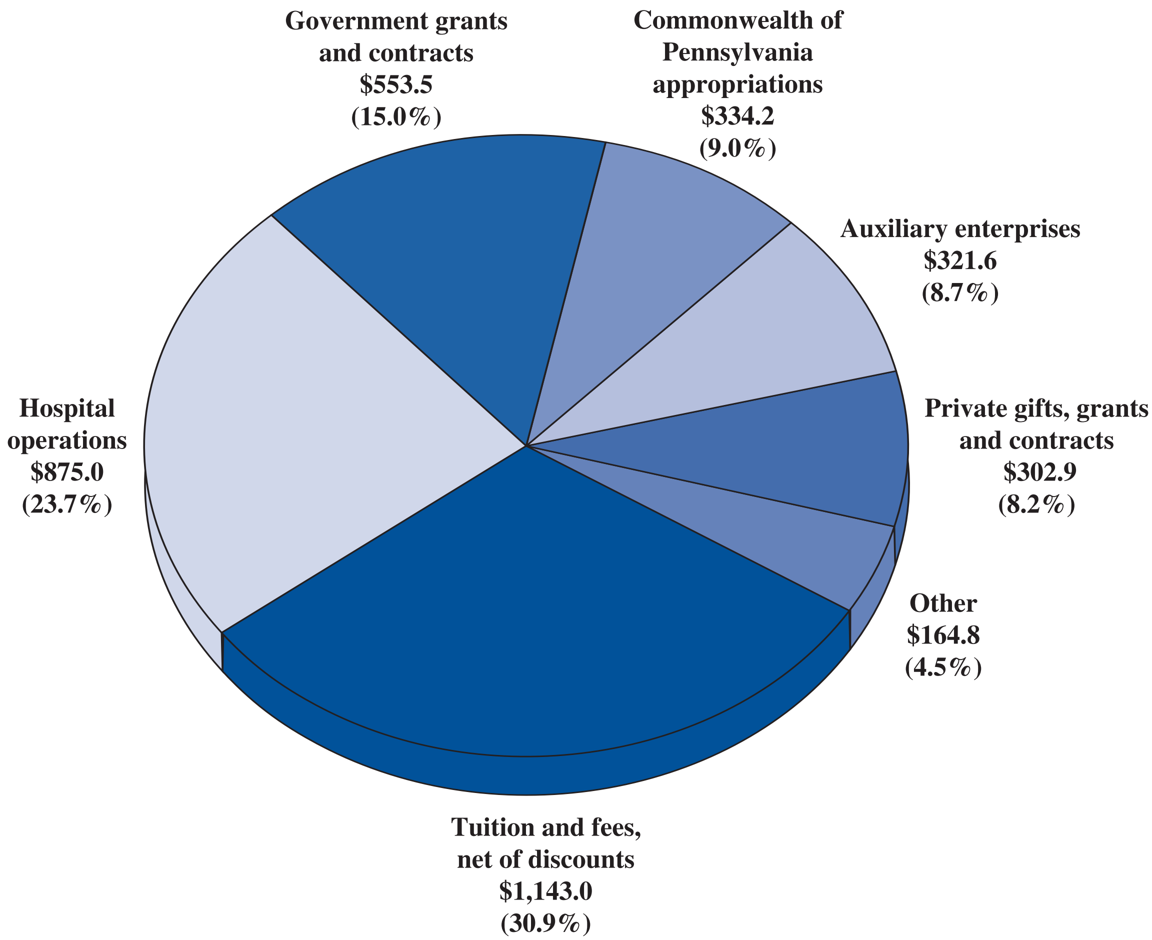
VIRTUE LIBERTY AND INDEPENDENCE

CONTENTS

REVENUES BY SOURCE

For the Year Ended June 30, 2008

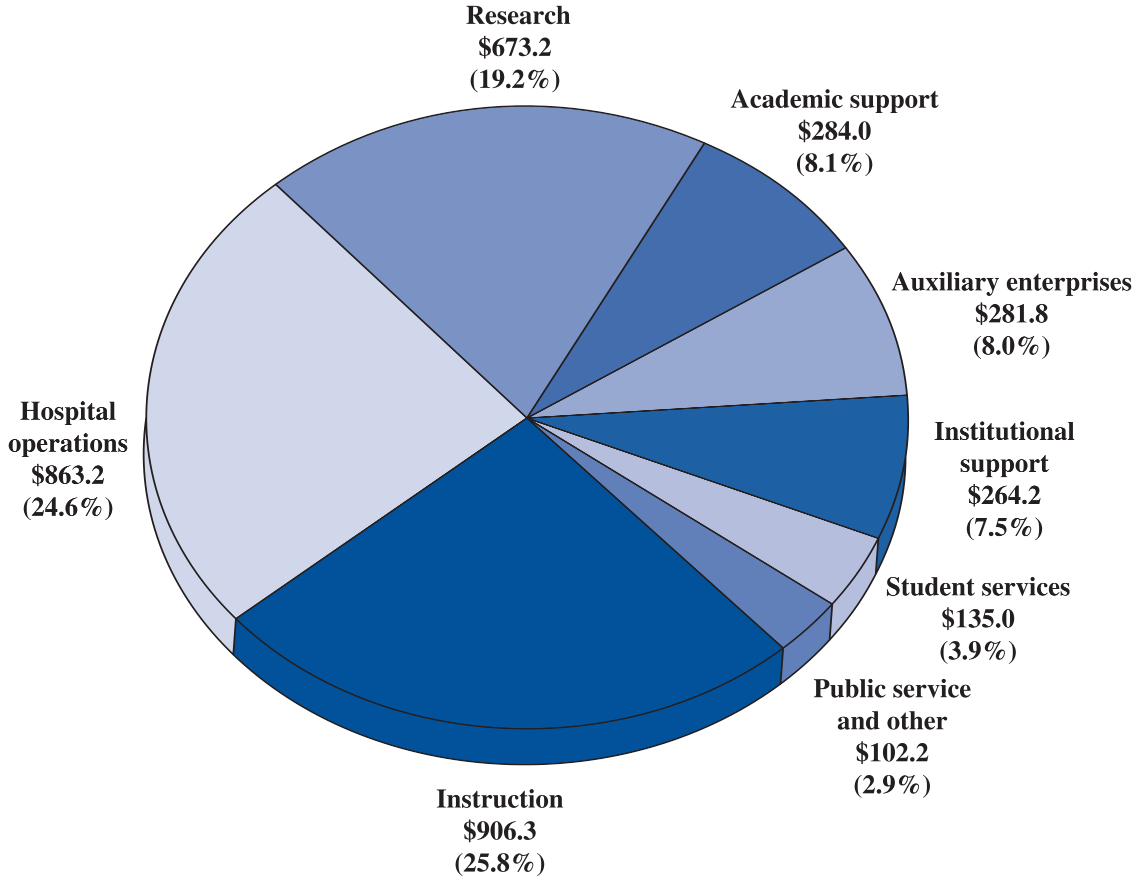
(in Millions)



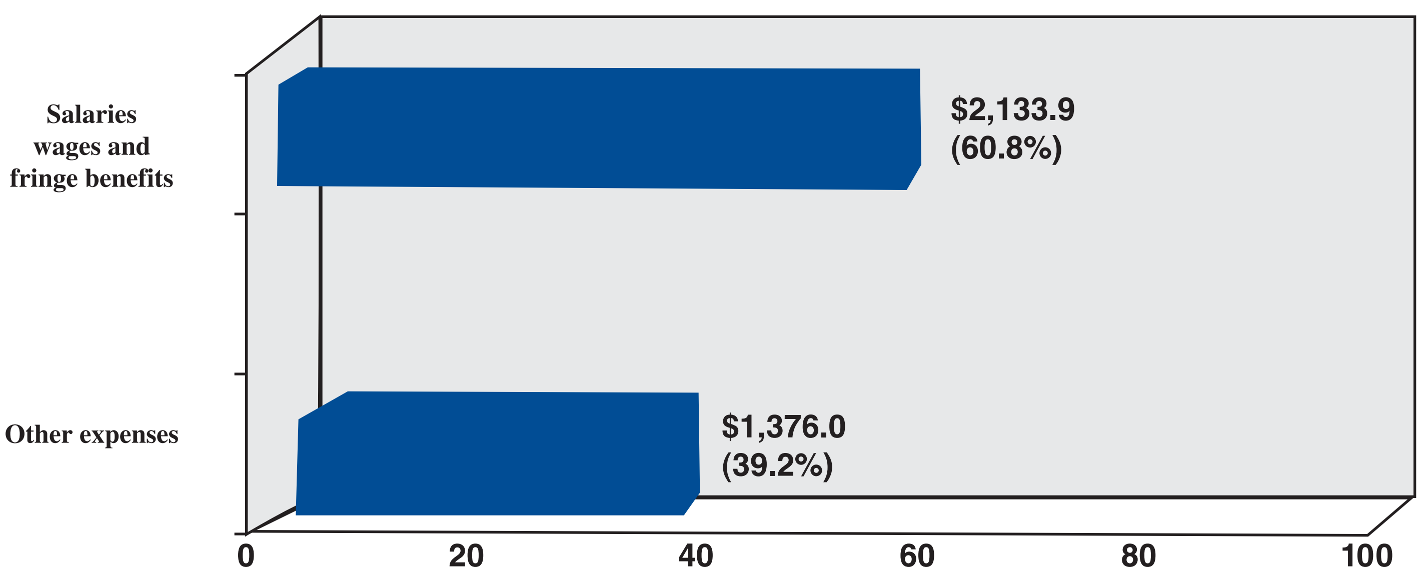
EXPENSES BY FUNCTION

For the Year Ended June 30, 2008

(in Millions)



APPLICATION BY OBJECT



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Joseph J. Doncsecz
Corporate Controller

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

814-865-1355
Fax: 814-863-0701

September 30, 2008

Dr. Graham Spanier, President
The Pennsylvania State University

Dear Dr. Spanier:

The audited consolidated financial statements of The Pennsylvania State University and subsidiaries (the "University") for the fiscal year ended June 30, 2008 are presented on the accompanying pages. These financial statements represent a complete and permanent record of the finances of the University for the 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,

Joseph J. Doncsecz
Corporate Controller

Albert G. Horvath
Vice President for Finance & Business

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

Deloitte.

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INDEPENDENT AUDITORS' REPORT

To the Board of Trustees of The Pennsylvania State University
University Park, Pennsylvania

We have audited the accompanying consolidated statements of financial position of The Pennsylvania State University and subsidiaries (the "University") as of June 30, 2008 and 2007, and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of the management of the University. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 9 to the consolidated financial statements, during the year ended June 30, 2007, the University adopted Statement of Financial Accounting Standards ("SFAS") No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans".

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

Deloitte & Touche LLP

September 30, 2008

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
ASSETS
JUNE 30, 2008 AND 2007
(in thousands)

	June 30, 2008	June 30, 2007
Current assets:		
Cash and cash equivalents - in short-term operating portfolios	$ 518,227	$ 386,578
Cash and cash equivalents - in operating investment portfolios	78,229	59,978
Short-term investments	298,037	236,297
Deposits	24,837	21,104
Accounts receivable, net of allowances of $22,226 and $24,139	373,950	333,058
Contributions receivable, net	39,269	42,456
Loans to students, net of allowances of $4,601 and $4,886	10,422	11,305
Inventories	29,916	27,916
Prepaid expenses and other assets	53,096	48,857
Investments held under securities lending program	265,725	309,682
Total current assets	1,691,708	1,477,231
Noncurrent assets:		
Deposits held by bond trustees	6,770	18,268
Contributions receivable, net	106,430	91,863
Loans to students, net of allowances of $14,570 and $12,564	33,192	28,793
Deferred bond costs	6,268	5,106
Total investment in plant, net	2,732,744	2,552,935
Beneficial interest in perpetual trusts	13,673	17,078
Investments	3,066,609	3,066,165
Total noncurrent assets	5,965,686	5,780,208
Total assets	$ 7,657,394	$ 7,257,439

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
LIABILITIES AND NET ASSETS
JUNE 30, 2008 AND 2007
(in thousands)

	June 30, 2008	June 30, 2007
Current liabilities:		
Accounts payable and other accrued expenses	$ 383,612	$ 348,112
Deferred revenue	206,519	193,148
Long-term debt	53,098	50,937
Present value of annuities payable	5,520	5,282
Accrued postretirement benefits	29,139	28,944
Liability under securities lending program	265,725	309,682
Total current liabilities	943,613	936,105
Noncurrent liabilities:		
Deposits held in custody for others	37,750	34,088
Deferred revenue	19,556	22,396
Long-term debt	969,764	860,569
Present value of annuities payable	36,018	36,907
Accrued postretirement benefits	895,198	805,618
Refundable United States Government student loans	35,442	32,894
Other liabilities	130,599	124,499
Total noncurrent liabilities	2,124,327	1,916,971
Total liabilities	3,067,940	2,853,076
Net assets:		
Unrestricted -		
Undesignated	987	950
Designated for specific purposes	1,576,579	1,453,003
Net investment in plant	1,602,885	1,524,097
Total unrestricted	3,180,451	2,978,050
Temporarily restricted	514,094	587,469
Permanently restricted	894,909	838,844
Total net assets	4,589,454	4,404,363
Total liabilities and net assets	$ 7,657,394	$ 7,257,439

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2008
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues and other support:				
Tuition and fees, net of discounts of $99,518	$ 1,143,041	$ -	$ -	$ 1,143,041
Commonwealth of Pennsylvania -				
Appropriations	334,230	-	-	334,230
Special contracts	104,967	-	-	104,967
Department of General Services projects	53,499	-	-	53,499
United States Government grants and contracts	394,986	-	-	394,986
Private grants and contracts	149,374	-	-	149,374
Gifts and pledges	56,084	47,530	49,871	153,485
Endowment income/(loss), net	25,034	(81,828)	9,382	(47,412)
Other investment income/(loss), net	35,818	(9,649)	266	26,435
Sales and services of educational activities	49,726	-	-	49,726
Recovery of indirect costs	118,637	-	-	118,637
Auxiliary enterprises	321,632	-	-	321,632
Hospital operations	874,977	-	-	874,977
Other sources	17,954	706	(1,280)	17,380
Net assets released from restrictions	27,493	(27,493)	-	-
Total revenues and other support	3,707,452	(70,734)	58,239	3,694,957
Expenses and losses:				
Educational and general -				
Instruction	906,308	-	-	906,308
Research	673,244	-	-	673,244
Public service	91,836	-	-	91,836
Academic support	283,954	-	-	283,954
Student services	134,974	-	-	134,974
Institutional support	264,174	-	-	264,174
Total educational and general	2,354,490	-	-	2,354,490
Auxiliary enterprises	281,817	-	-	281,817
Hospital operations	863,239	-	-	863,239
Write-offs and disposals of assets	5,505	-	-	5,505
Actuarial adjustment on annuities payable	-	2,641	2,174	4,815
Total expenses and losses	3,505,051	2,641	2,174	3,509,866
Increase (decrease) in net assets	202,401	(73,375)	56,065	185,091
Net assets at the beginning of the year	2,978,050	587,469	838,844	4,404,363
Net assets at the end of the year	$ 3,180,451	$ 514,094	$ 894,909	$ 4,589,454

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2007
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues and other support:				
Tuition and fees, net of discounts of $91,906	$ 1,057,691	$ -	$ -	$ 1,057,691
Commonwealth of Pennsylvania -				
Appropriations	327,715	-	-	327,715
Special contracts	108,448	-	-	108,448
Department of General Services projects	7,688	-	-	7,688
United States Government grants and contracts	360,026	-	-	360,026
Private grants and contracts	136,130	-	-	136,130
Gifts and pledges	61,030	38,455	75,218	174,703
Endowment income, net	116,526	163,911	10,472	290,909
Other investment income, net	127,615	11,416	153	139,184
Sales and services of educational activities	40,599	-	-	40,599
Recovery of indirect costs	109,634	-	-	109,634
Auxiliary enterprises	291,773	-	-	291,773
Hospital operations	832,328	-	-	832,328
Other sources	16,339	1,091	1,412	18,842
Net assets released from restrictions	26,394	(26,394)	-	-
Total revenues and other support	3,619,936	188,479	87,255	3,895,670
Expenses and losses:				
Educational and general -				
Instruction	826,097	-	-	826,097
Research	625,519	-	-	625,519
Public service	79,035	-	-	79,035
Academic support	261,816	-	-	261,816
Student services	121,785	-	-	121,785
Institutional support	225,420	-	-	225,420
Total educational and general	2,139,672	-	-	2,139,672
Auxiliary enterprises	267,671	-	-	267,671
Hospital operations	806,062	-	-	806,062
Write-offs and disposals of assets	5,004	-	-	5,004
Actuarial adjustment on annuities payable	-	1,371	9,272	10,643
Total expenses and losses	3,218,409	1,371	9,272	3,229,052
Increase in net assets before cumulative effect	401,527	187,108	77,983	666,618
Cumulative effect of adoption of new accounting principle	(103,601)	-	-	(103,601)
Increase in net assets	297,926	187,108	77,983	563,017
Net assets at the beginning of the year	2,680,124	400,361	760,861	3,841,346
Net assets at the end of the year	$ 2,978,050	$ 587,469	$ 838,844	$ 4,404,363

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2008 AND 2007
(in thousands)

	June 30, 2008	June 30, 2007
Cash flows from operating activities:		
Increase in net assets	$ 185,091	$ 563,017
Adjustments to reconcile change in net assets to net cash provided by operating activities -		
Actuarial adjustment on annuities payable	4,815	10,644
Contributions restricted for long-term investment	(66,835)	(91,184)
Interest and dividends restricted for long-term investment	(24,630)	(20,955)
Net realized and unrealized (gains)/losses on long-term investments	126,706	(270,579)
Depreciation and amortization expense	193,014	169,762
Write-offs and disposals of assets	5,850	5,330
Contributions of land, buildings and equipment	(2,789)	(2,625)
Buildings and equipment provided by Pennsylvania Department of General Services	(26,377)	(1,785)
Contribution to government student loan funds	4,054	254
Provision for bad debts	22,998	23,871
Cumulative effect of adoption of new accounting principle	-	103,601
Increase in deposits	(3,732)	(2,984)
Increase in receivables	(76,697)	(69,063)
Increase in inventories	(2,000)	(824)
Increase in prepaid expenses and other assets	(28,118)	(5,428)
Increase in accounts payable and other accrued expenses	36,119	7,904
Increase in deferred revenue	10,729	49,410
Increase in accrued postretirement benefits	89,774	44,015
Net cash provided by operating activities	447,972	512,381
Cash flows from investing activities:		
Purchase of land, buildings and equipment	(325,180)	(254,048)
Decrease in deposits held by bond trustees	11,388	357
Advances on student loans	(13,115)	(13,465)
Collections on student loans	6,976	10,346
(Increase)/decrease in investments held under securities lending program	43,956	(89,650)
Increase/(decrease) in liability under securities lending program	(43,956)	89,650
Purchase of investments	(5,065,459)	(3,433,859)
Proceeds from sale of investments	4,917,285	3,155,047
Net cash used in investing activities	(468,105)	(535,622)
Cash flows from financing activities:		
Contributions restricted for long-term investment	66,835	91,184
Interest and dividends restricted for long-term investment	24,630	20,955
Payments of annuity obligations	(5,571)	(5,327)
Proceeds from issuance of bonds	145,368	179,464
Principal payments on notes, bonds and capital leases	(61,714)	(121,303)
Proceeds related to government student loan funds, net of collection costs	485	480
Net cash provided by financing activities	170,033	165,453
Net increase in cash and cash equivalents	149,900	142,212
Cash and cash equivalents at the beginning of the year	446,556	304,344
Cash and cash equivalents at the end of the year	$ 596,456	$ 446,556

See notes to consolidated financial statements.

1. THE UNIVERSITY AND RELATED ENTITIES

The Pennsylvania State University ("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 10 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.

<u>Basis of Presentation</u>

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 endowments, 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 throughout the year. Income distributed to funds may be a combination of capital appreciation and earnings 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 accounting principles generally accepted in the United States of America 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.

Revenue Recognition

Tuition revenue is recognized in the fiscal year in which the substantial portion of the educational term occurs. Revenues for auxiliary enterprises are recognized as the related goods and services are delivered and rendered. Grant revenues are recognized as the eligible grant activities are conducted. Payments received in advance for tuition, goods and services are deferred.

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 with the revenue assigned to the appropriate category of restriction. Contributions receivable are recorded after discounting to the present value of the future cash flows.

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 future periods as final settlements are determined or such estimates change.

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

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, 2008 and 2007. The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable 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, as the total outstanding loans to students as of June 30, 2008 and 2007 have been made at the rates available to students for similar loans at such times. The fair value of investments is disclosed in Note 3. The fair value of the University's bonds payable is disclosed in Note 6.

Cash Flows

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

	2008	2007
Interest paid	$ 37,583,000	$ 33,932,000
Non-cash acquisitions of land, buildings and equipment	27,651,000	3,969,000
Non-cash construction costs/deferred lease obligation at TMSHMC	-	31,324,000

The University defines cash and cash equivalents based on the primary purpose of the investment portfolio that holds the investment. Due to the investment strategies of portfolio managers, there is $78,229,000 and $59,978,000 of cash and cash equivalents held in operating investment portfolios at June 30, 2008 and 2007, 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 the consolidated statements of activities. The University records derivative securities at market value with changes in market value reflected in the consolidated statements of activities.

The estimated fair value amounts for marketable debt and equity securities held by the University have been reviewed by the University and 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. This financial information includes assumptions and methods that were reviewed by University management. The University believes that the estimated fair value is a reasonable estimate of market value as of June 30, 2008 and 2007. Because the limited partnerships are not readily marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market existed, and such differences could be material.

Beneficial Interest in Perpetual Trusts

The University receives endowment income from investments of $13,673,000 and $17,078,000 held by outside trustees at June 30, 2008 and 2007, 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:

	2008	2007
Land	$ 91,506,000	$ 90,930,000
Buildings	3,472,408,000	3,197,891,000
Improvements other than buildings	445,576,000	422,692,000
Equipment	844,274,000	805,238,000
Total plant	4,853,764,000	4,516,751,000
Less accumulated depreciation	(2,121,020,000)	(1,963,816,000)
Total investment in plant, net	$ 2,732,744,000	$ 2,552,935,000

Asset Retirement Obligation

Effective June 30, 2006, the University adopted Financial Accounting Standards Board ("FASB") Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* ("FIN 47"). FIN 47 provides an interpretation of Statement of Financial Accounting Standard ("SFAS") No. 143, *Accounting for Retirement Obligations*, by clarifying that conditional asset retirement obligations meet the definition of a liability even though uncertainty may exist about the timing or method of settlement. Under the provisions of FIN 47, the University is obligated to record a liability for conditional asset retirement obligations. The University performed an analysis of such obligations and determined that asbestos abatement costs represented the University's primary source of such liabilities. The University reviewed all facilities and determined the timing, method and cost of asbestos abatement using a variety of assumptions and estimates. Conditional asset retirement obligations of $46,085,000 and $44,248,000 are included in other noncurrent liabilities in the consolidated statement of financial position at June 30, 2008 and 2007, respectively.

Accounting Pronouncements

For the year ended June 30, 2008, the University implemented FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109"* ("FIN 48"). FIN 48 prescribes the minimum recognition threshold a tax position must meet in connection with accounting for uncertainties in income tax positions taken or expected to be taken by an entity, before being measured and recognized in the financial statements. The adoption of FIN 48 did not have a material impact on the University's financial statements. The University files U.S. federal tax returns. No returns are currently under examination. The statute of limitations on the University's U.S. federal information returns remain open for three years following the year they are filed.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position ("FSP") 157-2, *Effective Date of FASB Statement No. 157* which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis, at least annually, until fiscal years beginning after November 15, 2008. SFAS 157 is effective for the University in 2009. University management is currently evaluating the impact of SFAS 157.

In February 2007, SFAS 159, *Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement 115* ("SFAS 159") was issued. SFAS 159, which extends the availability of the fair value option to assets and liabilities, is effective for the University in 2009. The University does not expect the adoption of SFAS 159 to have a material impact on its financial position or results of operations.

In August 2008, the FASB issued FASB Staff Position (FSP) FAS 117-1, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), and Enhanced Disclosures for All Endowment Funds.* The FSP provides guidance on the net asset classification of donor-restricted funds for a not-for-profit organization that is subject to an enacted version of UPMIFA of 2006. UPMIFA is a model act approved by the Uniform Law Commission that serves as a guideline for states to use in enacting legislation. This FSP also improves disclosures about an organization's endowment funds (both donor-restricted endowment funds and board-designated endowment funds), whether or not the organization is subject to UPMIFA. The FSP is effective for the University in 2009. University management is currently evaluating the impact of the FSP.

Reclassifications

Certain 2007 amounts related to private gifts, grants and contracts of $310,833,000 have been reclassified to conform with 2008 presentation of private grants and contracts of $136,130,000 and gifts and pledges of $174,703,000 within the consolidated statement of activities.

3. INVESTMENTS

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

	2008	2007
Money markets	$ 178,084,000	$ 297,898,000
Fixed income:		
U.S. government/agency	525,362,000	397,180,000
U.S. corporate	601,413,000	358,782,000
Foreign	129,624,000	76,227,000
Other	621,133,000	679,145,000
Equities	856,545,000	1,002,935,000
Private capital	530,714,000	550,273,000
Investments held under securities lending program	265,725,000	309,682,000
Total	$3,708,600,000	$3,672,122,000

Other fixed income investments consist of collateralized mortgage obligations, mortgage-backed securities, asset-backed securities and municipal bonds. Equity investments are comprised of domestic and foreign common stocks. Private capital consists primarily of interests in real estate, private equity, venture capital, energy and hedge fund limited partnerships. Certain 2007 amounts classified as other fixed income investments totaling $69,168,000 have been reclassified as private capital to conform with 2008 presentation of these investment categories.

The following schedule summarizes the investment return and its classification in the consolidated statement of activities for the year ended June 30, 2008:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Dividends and interest	$ 98,359,000	$ 6,907,000	$ 9,619,000	$ 114,885,000
Net realized gains, including endowment spending	57,189,000	21,238,000	29,000	78,456,000
Net unrealized losses	(94,696,000)	(119,622,000)	-	(214,318,000)
Total returns	$ 60,852,000	$ (91,477,000)	$ 9,648,000	$ (20,977,000)

The following schedule summarizes the investment return and its classification in the consolidated statement of activities for the year ended June 30, 2007:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Dividends and interest	$ 130,700,000	$ 4,243,000	$ 10,625,000	$ 145,568,000
Net realized gains, including endowment spending	38,690,000	53,757,000	-	92,447,000
Net unrealized gains	74,751,000	117,327,000	-	192,078,000
Total returns	$ 244,141,000	$ 175,327,000	$ 10,625,000	$ 430,093,000

In the management of investments, the University authorizes certain of its investment managers to purchase derivative securities to attain a desired market position; and the University may directly invest in derivative securities to attain a desired market position. The University does not trade or issue derivative financial instruments other than through the investment management practices noted above. Gains and losses from derivative instruments are reported in the consolidated statements of activities. Futures contracts, which are fully cash collateralized, are marked to market daily and are included in the carrying value of the University's investments. The market value of all derivative instruments is included in the market value of the University's investments. Futures contracts have minimal credit risk because the counterparties are the exchanges themselves. Fully cash collateralized derivative securities comprised approximately 2.8% of total investments at June 30, 2008. The University directly held no derivative securities at June 30, 2007.

Through an agreement with its primary investment custodian, the University participates in lending securities to brokers. Collateral is generally limited to cash, government securities, and irrevocable letters of credit. Both the investment custodian and the security borrowers have the right to terminate a specific loan of securities at any time. The University receives lending fees and continues to earn interest and dividends on the loaned securities. At June 30, 2008 and 2007, the University held $265,725,000 and $309,682,000, respectively, of cash and cash equivalents as collateral deposits for the securities lending program. The collateral is included as an asset and the obligation to return such collateral is presented as a liability in the consolidated statements of financial position. The securities on loan had an estimated fair value of $261,096,000 and $303,370,000 at June 30, 2008 and 2007, respectively.

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 $1,522,988,000 and $1,587,197,000 at June 30, 2008 and 2007, 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 as of June 30:

	2008	2007
Market value per unit	$ 30.63	$ 32.57
Annual net gains/(losses) per unit	$ (1.94)	$ 4.29
Average annual earnings per unit, exclusive of gains and losses	$ 0.81	$ 1.42

5. CONTRIBUTIONS RECEIVABLE

Contributions receivable are summarized as follows as of June 30:

	2008	2007
In one year or less	$ 51,814,000	$ 52,568,000
Between one year and five years	67,557,000	64,024,000
More than five years	89,864,000	76,511,000
	209,235,000	193,103,000
Less allowance	(10,578,000)	(9,459,000)
Less discount	(52,958,000)	(49,325,000)
Contributions receivable, net	$ 145,699,000	$ 134,319,000

At June 30, 2008 and 2007, the University has received bequest intentions and certain other conditional promises to give of $31,328,000 and $30,748,000, respectively. These intentions and conditional promises to give are not included in the consolidated financial statements.

6. LONG-TERM DEBT

The various bond issues, note payable and capital lease obligations that are included in long-term debt in the statements of financial position consist of the following:

	2008	2007
The Pennsylvania State University Bonds		
Series 2008A	$ 77,670,000	$ -
Series 2008B	8,310,000	-
Series 2007A	90,570,000	90,570,000
Series 2007B	76,120,000	80,025,000
Series 2005	94,885,000	96,555,000
Series 2004A	58,845,000	59,930,000
Refunding Series 2003	24,350,000	26,260,000
Series of 2002	100,000,000	100,000,000
Refunding Series 2002	112,240,000	126,835,000
Refunding Series 2001	26,565,000	34,590,000
Series A of 2001	75,000,000	75,000,000
Series B of 1997	-	8,805,000
Pennsylvania Higher Educational Facilities Authority University Revenue Bonds (issued for The Pennsylvania State University)		
Series 2006	4,480,000	4,650,000
Series 2004	5,015,000	5,215,000
Series 2002	5,670,000	5,965,000
Lycoming County Authority College Revenue Bonds (issued for Penn College)		
Series 2008	55,000,000	-
Series 2005	14,645,000	15,225,000
Series 2003	3,315,000	6,495,000
Series 2002	29,650,000	29,995,000
Series 2000	39,370,000	39,370,000
Series 1997	-	11,300,000
Series 1993	12,519,000	11,954,000
Total bonds payable	914,219,000	828,739,000
Unamortized bond premiums	27,231,000	24,704,000
Note payable and capital leases		
Demand note payable	10,000,000	10,000,000
Capital lease obligations	71,412,000	16,739,000
Deferred lease obligation	-	31,324,000
Total note payable and capital leases	81,412,000	58,063,000
Total long-term debt	$1,022,862,000	$ 911,506,000

The Pennsylvania State University Bonds

- Series 2008A and 2008B – general obligation bonds issued in April 2008 for the purpose of funding various construction and renovation projects and for the current refunding of the Series 1997B Bonds, which previously refunded the Series 1992B Bonds. The University, in conjunction with the issuance of the Series 2008B bonds, legally defeased the Series B of 1997 Bonds, with an outstanding principal of $8,105,000, by irrevocably depositing $8,364,000 in an escrow fund to be used to pay the interest accrued, maturing principal on and the redemption price of the refunded bonds. As a result of the current refunding transaction, amounts related to the Series 1997B Bonds have been removed from the University's June 30, 2008 statement of financial position. Principal payments on the Series 2008A and 2008B bonds are due annually, in amounts ranging from $830,000 to $7,695,000 through August 2029. The bonds pay interest at rates ranging from 3.00% to 5.00%. The 2008A Bonds are subject to early redemption provisions, at the option of the University, beginning February 2018.

- Series 2007A and 2007B – general obligation bonds issued in January 2007 for the purpose of funding various construction and renovation projects and for the advance refunding of the Series 1997A Bonds. The University, in conjunction with the issuance of the Series 2007B bonds, legally defeased the Series A of 1997 Bonds, with an outstanding principal of $84,540,000, by irrevocably depositing $88,341,000 in an escrow fund to be used to pay the interest accrued, maturing principal on and the redemption price of the refunded bonds. As a result of the advance refunding transaction, amounts related to the Series 1997A Bonds were removed from the University's June 30, 2007 statement of financial position. Principal payments on the Series 2007A and 2007B bonds are due annually, in amounts ranging from $2,770,000 to $5,955,000 through August 2027, with additional payments of $11,115,000 due August 2028 and $70,905,000 due August 2036. The bonds pay interest at rates ranging from 3.55% to 5.25% and are subject to sinking fund redemption beginning August 2023 and early redemption provisions, at the option of the University, beginning August 2016.

- Series 2005 – general obligation bonds issued in January 2005 for the purpose of funding various construction projects. Principal payments are due annually in amounts ranging from $1,720,000 to $2,745,000 through September 2019, with additional payments of $15,990,000, $20,550,000 and $32,485,000 due September 2024, 2029 and 2034, respectively. The bonds pay interest at rates ranging from 3.00% to 5.00% and are subject to sinking fund redemption beginning September 2020 and early redemption provisions, at the option of the University, beginning September 2015.

- Series 2004A – general obligation bonds issued in April 2004 for the purpose of funding various construction projects. Principal payments are due annually in amounts ranging from $1,115,000 to $1,825,000 through September 2019, with additional payments of $10,625,000, $13,635,000 and $17,515,000 due September 2024, 2029 and 2034, respectively. The bonds pay interest at rates ranging from 3.00% to 5.00% and are subject to sinking fund redemption beginning September 2020 and early redemption provisions, at the option of the University, beginning September 2014.

- Refunding Series 2003 – general obligation bonds issued in March 2003 for the purpose of refunding the Refunding Series 1993A and to pay costs associated with issuing the 2003 Refunding Bonds. Principal payments are due annually in amounts ranging from $1,995,000 to $2,970,000 through March 2018. The bonds pay interest at rates ranging from 3.25% to 5.25% and are subject to early redemption provisions, at the option of the University, beginning March 2013.

- Series of 2002 and Series A of 2001 – general obligation bonds issued in May 2002 for the purpose of funding a portion of the costs of the acquisition, construction, equipping, renovation and improvement of certain facilities of the University and April 2001 for the purpose of funding various construction projects, respectively. The bonds are currently paying interest on a variable rate basis; however, the University has the option to convert to another variable rate or to a fixed rate basis (such rates are generally determined on a market basis). The bonds currently pay interest at 1.51% with adjustment on a weekly basis to the rate 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 standby bond purchase agreements with banks to provide liquidity in case of tender. The principal amount of the Series of 2002 bonds is due March 2032; and the principal amount of the Series A of 2001 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.

- Refunding Series 2002 – general obligation bonds issued in May 2002 for the purpose of refunding the Second Refunding 1992A Series (such bonds were previously issued to refund the Second Refunding 1988 Series, 1989 Series and 1991 Series Bonds). Principal payments are due annually, in amounts ranging from $4,585,000 to $16,540,000 through August 2016. The bonds pay interest at rates ranging from 4.79% to 5.25%. The bonds are not subject to redemption prior to maturity.

- Refunding Series 2001 – general obligation bonds issued in December 2001 for the purpose of refunding the Refunding Series 1992 Bonds (such bonds were previously issued to refund the 1986 Series and the First Refunding Series of 1988 Bonds). Principal payments are due annually, in amounts ranging from $8,425,000 to $9,290,000 through March 2011. The bonds pay interest at rates ranging from 5.00% to 5.25%. The bonds are not subject to redemption prior to maturity.

<u>Pennsylvania Higher Educational Facilities Authority University Revenue Bonds (issued for The Pennsylvania State University)</u>

- Series 2006 – Pennsylvania Higher Educational Facilities Authority (PHEFA) University Revenue Bonds issued by the Pennsylvania State University in April 2006 for the purpose of funding the costs of sprinkler system installation and repairs in certain of the University's dormitories during the period 2006-2008, related design costs and payment of issuance costs. Principal payments are due annually in amounts ranging from $175,000 to $280,000 through September 2020, with an additional payment of $1,610,000 due September 2025. The bonds pay interest at rates ranging from 3.65% to 5.125%, with PHEFA subsidizing the annual interest cost to the University for interest rates greater than 3.00%. The bonds are subject to sinking fund redemption beginning September 2021 and early redemption provisions, at the option of the University, beginning September 2016.

- Series 2004 – Pennsylvania Higher Educational Facilities Authority University Revenue Bonds issued by the Pennsylvania State University in May 2004 for the purpose of funding the costs of sprinkler system installation and repairs in certain of the University's dormitories during 2004-2005. Principal payments are due annually in amounts ranging from $205,000 to $325,000 through September 2019, with an additional payment of $1,905,000 due September 2024. The bonds pay interest at rates ranging from 3.10% to 5.00%, with PHEFA subsidizing the annual interest cost to the University for interest rates greater than 3.00%. The bonds are subject to sinking fund redemption beginning September 2020 and early redemption provisions, at the option of the University, beginning September 2014.

- Series 2002 – Pennsylvania Higher Educational Facilities Authority University Revenue Bonds issued by the Pennsylvania State University in June 2002 for the purpose of funding the costs of sprinkler system installation and repairs in certain of the University's dormitories during the period 2002 through 2004. Principal payments are due annually in amounts ranging from $305,000 to $425,000 through March 2017, with an additional payment of $2,435,000 due March 2022. The bonds pay interest at rates ranging from 3.75% to 5.00%, with PHEFA subsidizing the annual interest cost to the University for interest rates greater than 3.00%. The bonds are subject to sinking fund redemption beginning March 2018 and early redemption provisions, at the option of the University, beginning March 2011.

<u>Lycoming County Authority College Revenue Bonds (issued for Penn College)</u>

- Series 2008 – Lycoming County Authority College Revenue Bonds issued by Penn College in February 2008 for the purpose of funding various construction projects at the Penn College campus. Principal payments are due annually in amounts ranging from $1,455,000 to $4,140,000 through October 2037. The bonds pay interest at rates ranging from 3.50% to 5.50%.

- Series 2005 – Lycoming County Authority College Revenue Bonds issued by Penn College in February 2005 for the purpose of refunding $7,765,000 of the Authority's College Bonds, Series of 1997, funding a deposit into the debt service reserve account, funding various construction and renovation projects and payment of costs of issuance of 2005 Bonds. Principal payments are due annually in amounts ranging from $500,000 to $1,855,000 through January 2025. The bonds pay interest at rates ranging from 3.00% to 5.00%.

- Series 2003 – Lycoming County Authority College Revenue Bonds issued by Penn College in February 2003 for the purpose of refunding $17,385,000 of the Authority's College Revenue Bonds, Series of 1993 and the payment of costs of issuance of 2003 Bonds. Principal payment is due in the amount of $3,315,000 in November 2008. The bonds pay interest at rates ranging from 4.00% to 4.625%.

- Series 2002 – Lycoming County Authority College Revenue Bonds issued by Penn College in May 2002 for the purpose of funding various construction projects at the Penn College campus. Principal payments are due annually in amounts ranging from $350,000 to $2,775,000 through May 2032. The bonds pay interest at rates ranging from 4.00% to 5.25%.

- Series 2000 – 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, advance refunding $4,235,000 of the 1997 Lycoming County Authority College Revenue Bonds (1997 Series Bonds), funding of a deposit to the debt service fund reserve account established under the indenture and payment of the costs of issuance of the Series 2000 Bonds. Principal payments are due annually in amounts ranging from $30,000 to $5,225,000 through July 2030. The bonds pay interest at rates ranging from 4.75% to 5.50%.

- Series 1997 – 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 in amounts ranging from $275,000 to $5,010,000 through July 2018. The bonds pay interest at rates ranging from 4.90% to 5.25%. The 1997 Series Bonds were refunded by the 2000 Series Bonds at par amounting to $4,235,000. These bonds were paid in full during 2008.

- Series 1993 – Lycoming County Authority College Revenue Bonds issued by Penn College in 1993 for the purpose of undertaking a series of capital improvement projects. Principal payments are due annually in amounts ranging from $450,000 to $1,302,000 through November 2015. The bonds pay interest at rates ranging from 6.00% to 6.15%.

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

Year	Annual Installments
2009	$ 37,130,000
2010	35,460,000
2011	35,335,000
2012	27,630,000
2013	29,035,000
Thereafter	749,629,000

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, 2008, the carrying value and estimated fair value of the University's bonds payable, including issuance premiums, are $941,450,000 and $934,952,000, respectively. At June 30, 2007, the carrying value and estimated fair value of the University's bonds payable, including issuance premiums, were $853,443,000 and $845,086,000, respectively. Certain bond issues have associated issuance premiums, these issuance premiums total $27,231,000 and $24,704,000 at June 30, 2008 and 2007, respectively and are presented within the statement of financial position as long-term debt. These issuance premiums will be amortized over the term of the respective outstanding bonds.

Note payable and capital leases

A $10,000,000 demand note payable bearing interest at a variable rate (3.00% at June 30, 2008) is included in the current portion of long-term debt within the statements of financial position.

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 $82,870,000 and $26,946,000 at June 30, 2008 and 2007, 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, 2008 are as follows:

Year	
2009	$ 8,378,000
2010	8,279,000
2011	8,210,000
2012	7,796,000
2013	6,905,000
Thereafter	162,337,000
Total minimum lease payments	201,905,000
Less imputed interest	(130,493,000)
Capital lease obligation	71,412,000
Current portion	4,030,000
Long-term portion	$ 67,382,000

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 $1,489,000 and $1,329,000 in investments at June 30, 2008 and 2007, 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 Mount Nittany Medical Center, which has been leased by ADG-HDA for a term of sixty years. The University has subleased portions of the Building to the Mount Nittany Medical Center and other healthcare related entities.

During 2007, TMSHMC entered into a lease agreement for a facility currently under construction located on the Medical Center's campus. As a result of certain provisions contained within the lease and related agreements, the Medical Center accounted for the facility as an owned facility and therefore recognized non-cash construction costs incurred as of June 30, 2007 (included as construction in progress), together with a corresponding deferred lease obligation, as of June 30, 2007, in the amount of $31,324,000. During 2008, TMSHMC capitalized additional costs related to the facility in the amount of $17,276,000. In March 2008, the facility was opened and the deferred obligation in the amount of $48,600,000 was reclassified to a capital lease obligation.

7. OPERATING LEASES

The University has certain lease agreements in effect which are considered operating leases. During the year ended June 30, 2008, the University recorded expenses of $22,481,000 for leased equipment and $15,619,000 for leased building space. During the year ended June 30, 2007, the University recorded expenses of $23,570,000 for leased equipment and $13,541,000 for leased building space.

Future minimum lease payments under operating leases as of June 30, 2008 are as follows:

Year	
2009	$ 16,299,000
2010	12,801,000
2011	10,440,000
2012	7,798,000
2013	6,186,000
Thereafter	40,705,000
Total minimum lease payments	$ 94,229,000

8. 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 ($10,614,000 and $9,866,000 for the years ended June 30, 2008 and 2007, respectively). The University's total cost for retirement benefits, included in expenses, is $99,263,000 and $92,863,000 for the years ended June 30, 2008 and 2007, respectively.

9. POSTRETIREMENT BENEFITS

The University sponsors a retiree medical plan covering eligible retirees and eligible dependents. For the 2008 benefit plan year, this program includes a Preferred Provider Organization ("PPO") plan for retirees and their dependents who are not eligible for Medicare, a Medicare Advantage Private Fee For Service ("PFFS") plan and a Medicare Supplement plan. In addition, the University provides retiree life insurance benefits of $5,000 at no cost to the retiree. A limited number of retirees have $10,000 of life insurance coverage; $5,000 of which is provided by the University and $5,000 is paid by the retiree.

Retirees are eligible for medical coverage and life insurance after they retire if:

- they are at least age 60 and have at least 15 years of regular full-time employment and participation in a University-sponsored medical plan immediately preceding the retirement date

OR

- regardless of age, if they have at least 25 years of regular full-time service. The last 10 of those 25 years of University service must be continuous and they must participate in a University - sponsored medical plan during the last 10 years immediately preceding the retirement date.

The retiree PPO medical plan and the $5,000 life insurance coverage are self-funded programs, and all medical claims, death benefits and other expenses are paid from the unrestricted net assets of the University. The PFFS plan and the Medicare Supplement plan are fully insured. The retirees pay varying amounts for coverage under the medical plan. As of January 1, 2008, the monthly amounts ranged from $10 to $221 depending on age and dependent coverage options selected.

Effective June 30, 2007, the University adopted SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* – an amendment of SFAS No's. 87, 88, 106 and 132(R) ("SFAS No. 158"). The new standard requires that the funded status of the plan be fully recognized as a net asset or liability within the statements of financial position. Additionally, SFAS No. 158 requires an employer to measure the funded status of the plan as of the date of the fiscal year-end statement of financial position. The University has historically measured and continues to measure the funded status of the plan as of June 30.

The incremental effect of adopting the provision of SFAS No. 158 on the University's statement of financial position at June 30, 2007 is as follows:

	Prior to Adoption	Effect of Adoption	As Reported
Accrued postretirement benefits	$ 730,961,000	$ 103,601,000	$ 834,562,000
Unrestricted net assets	$ 3,081,651,000	$ (103,601,000)	$ 2,978,050,000

Included in unrestricted net assets at June 30, 2008 and 2007 are the following amounts that have not yet been recognized in net periodic postretirement cost: unrecognized prior service cost (benefit) of ($194,389,000) and ($216,018,000) and unrecognized actuarial loss of $334,646,000 and $319,619,000, respectively.

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:

	2008	2007
Benefit obligation at beginning of year	$ 834,562,000	$ 822,552,000
Service cost	32,882,000	29,693,000
Interest cost	53,390,000	48,168,000
Actuarial loss	32,793,000	72,109,000
Benefits paid	(29,290,000)	(29,081,000)
Plan amendment	-	(178,478,000)
Plan assumptions	-	69,599,000
Benefit obligation at end of year	$ 924,337,000	$ 834,562,000

Change in plan assets:

	2008	2007
Fair value of plan assets at beginning of year	$ -	$ -
Employer contributions	29,290,000	29,081,000
Benefits paid	(29,290,000)	(29,081,000)
Fair value of plan assets at end of year	$ -	$ -
Funded status	$ (924,337,000)	$ (834,562,000)
Unrecognized prior service cost (benefit)	-	-
Unrecognized net actuarial loss	-	-
Accrued postretirement benefit expense	$ (924,337,000)	$ (834,562,000)

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

	2008	2007
Service cost	$ 32,882,000	$ 29,693,000
Interest cost	53,390,000	48,168,000
Amortization of prior service cost	(21,629,000)	(21,629,000)
Amortization of unrecognized net loss	17,766,000	16,863,000
Net periodic postretirement cost	$ 82,409,000	$ 73,095,000

The assumed healthcare cost trend rate used in measuring the accumulated postretirement benefit obligation was 9.00% and 9.50% for the 2007-2008 and 2006-2007 plan years, respectively, reduced by 0.50% per year to a fixed level of 5.00%. The weighted average postretirement benefit obligation discount rate was 6.25% for each of the years ended June 30, 2008 and 2007, respectively.

If the healthcare cost trend rate assumptions were increased by 1% in each year, the accumulated postretirement benefit obligation would be increased by $160,053,000 and $145,204,000 as of June 30, 2008 and 2007, 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 $17,898,000 and $16,311,000 as of June 30, 2008 and 2007, respectively. If the healthcare cost trend rate assumptions were decreased by 1% in each year, the accumulated postretirement benefit obligation would be decreased by $127,972,000 and $115,930,000 as of June 30, 2008 and 2007, 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 $13,958,000 and $12,664,000 as of June 30, 2008 and 2007, respectively.

The postretirement benefits expected to be paid in each year for 2009–2013 are $34,045,000, $36,427,000, $38,902,000, $41,391,000 and $43,614,000, respectively. The benefits expected to be paid in the five years from 2014-2018 are $259,031,000.

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.

10. THE MILTON S. HERSHEY MEDICAL CENTER

The University's wholly-owned subsidiary, TMSHMC, owns the assets of the clinical enterprise of the Hershey Medical Center complex. The University owns the Hershey Medical Center complex, including all buildings and land occupied by the University Hospital and operates 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.

11. CONTINGENCIES AND COMMITMENTS

<u>Contractual Obligations</u>

The University has contractual obligations for the construction of new buildings and for additions to existing buildings in the amount of $427,549,000 of which $311,370,000 has been paid or accrued as of June 30, 2008. 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 $280,520,000 as of June 30, 2008 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.

<u>Letters of Credit</u>

The University has outstanding letters of credit in the amount of $15,404,000 and $17,328,000 as of June 30, 2008 and 2007, 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.

<u>Self-Insurance</u>

The University has a coordinated program of commercial and self-insurance for medical malpractice claims at TMSHMC through the use of a qualified trust and a domestic captive insurance company in combination with a self-insured retention layer and is supplementing this program through participation in the Pennsylvania Medical Care Availability and Reduction of Error Fund ("Mcare Fund"), formerly the Pennsylvania Medical Professional Liability Catastrophe Loss Fund ("CAT Fund"), in accordance with Pennsylvania law. An estimate of the present value, discounted at 4%, of the medical malpractice claims liability in the amount of $74,234,000 and $72,877,000 is recorded as of June 30, 2008 and 2007, respectively.

On July 1, 2003, TMSHMC became self-insured for all medical malpractice claims asserted on or after July 1, 2003, for all amounts that are below the coverage of the TMSHMC's excess insurance policies and not included in the insurance coverage of the Mcare Fund. Under the self-insurance program, TMSHMC is required to maintain a malpractice trust fund in an amount at least equal to the expected loss of known claims. The balance of this trust fund was $24,648,000 and $16,399,000 at June 30, 2008 and 2007, respectively. TMSHMC intends to fund any claims due during the next year from cash flows from operations.

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 insurance coverage for excess obligations over $600,000 per incident. An estimate of the self-insured workers' compensation claims liability in the amount of $11,081,000 and $9,662,000 is recorded as of June 30, 2008 and 2007, respectively. The University has established a trust fund, in the amount of $11,001,000 and $9,955,000 at June 30, 2008 and 2007, respectively, as required by PA-DLI, to provide for the payment of claims under this self-insurance program. TMSHMC is self-insured for workers' compensation claims and has purchased an excess policy through a commercial insurer which covers individual claims in excess of $500,000 per incident for workers' compensation claims.

The University and TMSHMC are self-insured for certain health care benefits provided to employees. The University and TMSHMC have purchased excess policies which cover employee health benefit claims in excess of $500,000 and $300,000 per employee per year, respectively. The University and TMSHMC provide for reported claims and claims incurred but not reported.

<u>Litigation and Contingencies</u>

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 10), 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.

12. SUBSEQUENT EVENT

On September 29, 2008, the University was notified that Wachovia Bank N.A., as Trustee (the "Trustee") of the Common Fund for Short Term Investments (the "Fund") was initiating the process of terminating the Fund. As part of this termination plan the Trustee has established procedures for an orderly liquidation and distribution of the assets of the Fund to all participants. Liquidity in the Fund was restricted based upon each participant's account value as of the close of business on September 26, 2008. The University's holdings in the Fund as of September 26, 2008 were $465,335,000. As of September 30, 2008, the University has received 10% of the account value and fully anticipates that approximately 50% will be available for withdrawal by October 31, 2008. It is expected that 60% of the Fund will be available by December 31, 2008, 74% by September 30, 2009 and the balance of 26% thereafter. As a result, at June 30, 2008, the University designated $298,037,000 as short-term investments within the consolidated statements of financial position based on the estimate of the timing of the liquidation of the Fund. The University's investment in the Fund at June 30, 2007 of $236,297,000 was reclassified from cash and cash equivalents to short-term investments to conform with the 2008 presentation. The University has evaluated the impact of this termination plan and the availability of funds and has determined that the plan does not have a material impact on the University's financial statements or overall liquidity.

THE PENNSYLVANIA STATE UNIVERSITY

1855

VIRTUE LIBERTY AND INDEPENDENCE