PENNSTATE

Audited Financial Statements

The Pennsylvania State University
Fiscal Year Ended June 30, 2006

THE PENNSYLVANIA STATE UNIVERSITY

UNIVERSITY OFFICERS

as of September 29, 2006

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

STEPHEN J. MacCARTHY
Vice President for University
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

JOHN J. ROMANO
Vice President for
Commonwealth Campuses

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

VICKY L. TRIPONEY
Vice President for Student Affairs

CRAIG D. WEIDEMANN
Vice President for Outreach

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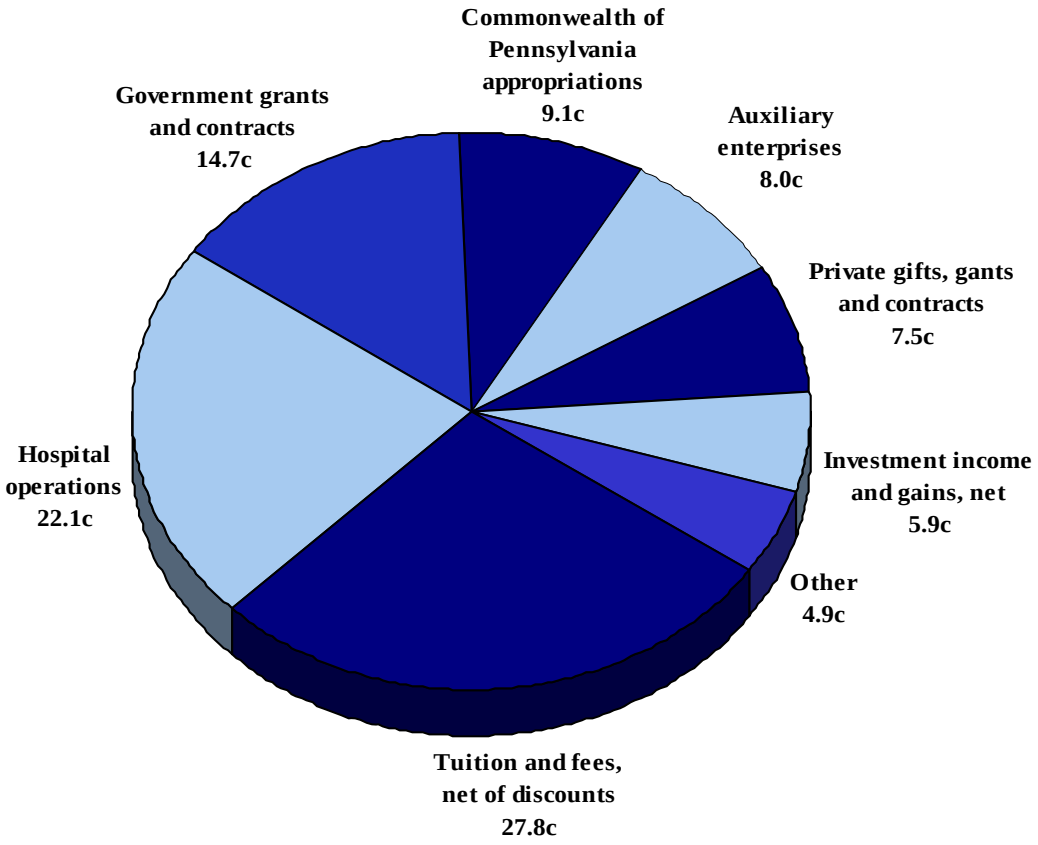
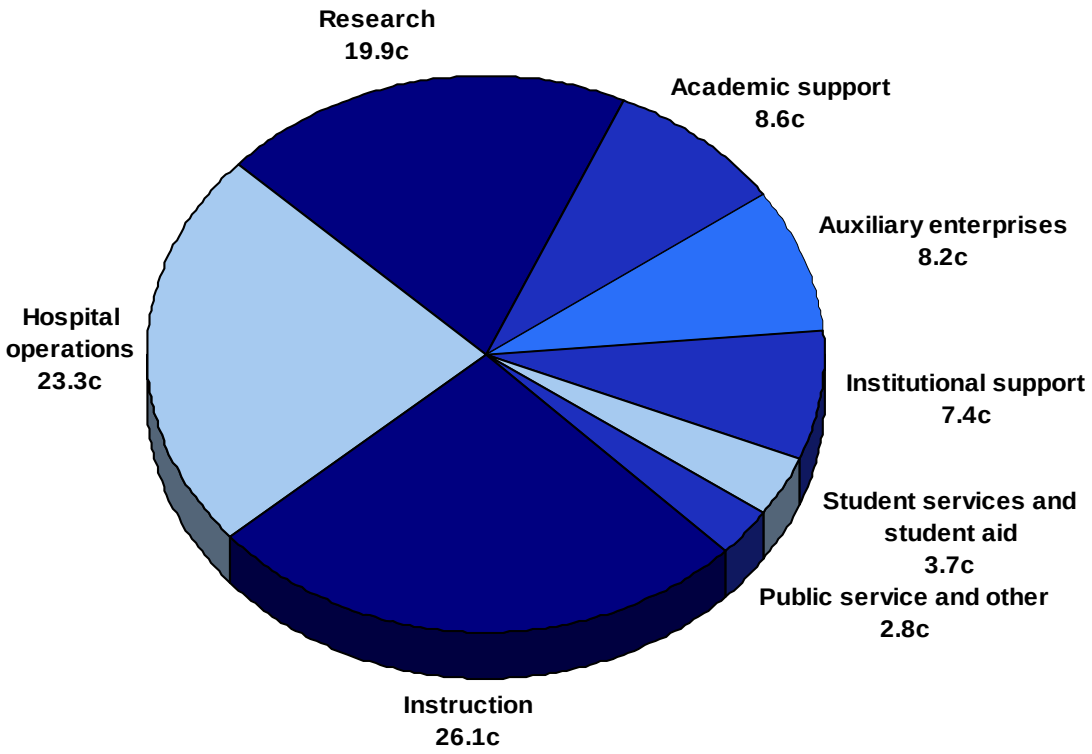
UNIVERSITY DOLLAR

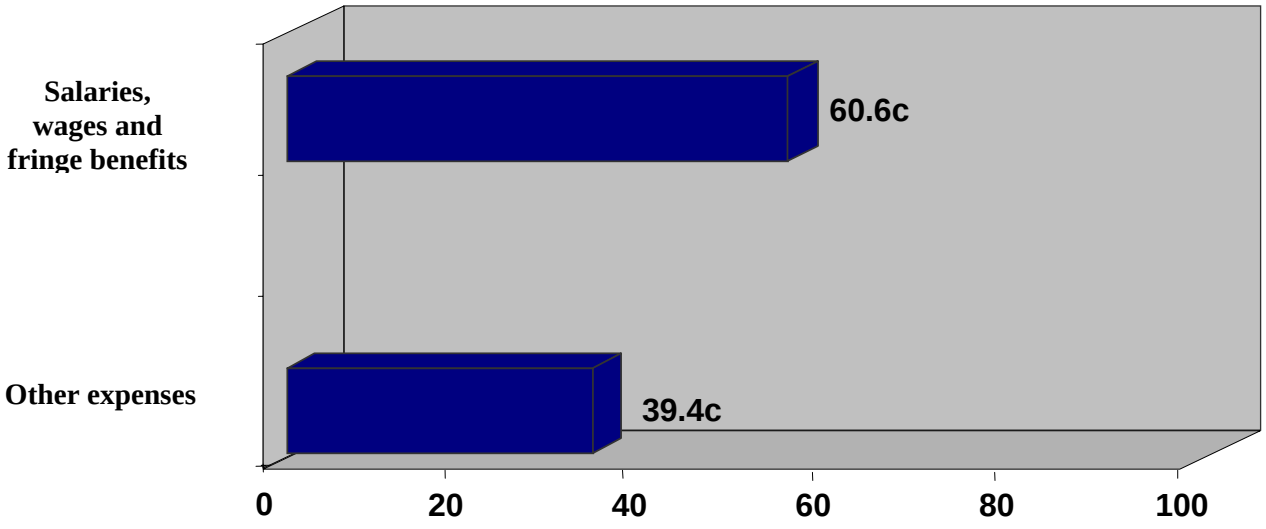
SOURCE



APPLICATION



APPLICATION BY OBJECT



PENNSTATE

1855

Kenneth S. Babe
Corporate Controller

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

814-865-1355

September 29, 2006

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, 2006 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,

Kenneth S. Babe
Corporate Controller

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

An Equal Opportunity University

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, 2006 and 2005, and the related consolidated statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the management of the University. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 audit provides a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, the University changed its method of accounting for asset retirement obligations in 2006.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the University at June 30, 2006 and 2005, 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 29, 2006

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
ASSETS
JUNE 30, 2006 AND 2005
(in thousands)

	June 30, 2006	June 30, 2005
Current assets:		
Cash and cash equivalents - in short-term operating portfolios	$ 428,798	$ 443,389
Cash and cash equivalents - in operating investment portfolios	36,719	45,889
Deposits	18,121	16,403
Accounts receivable, net of allowances of $19,599 and $18,839	305,601	270,597
Contributions receivable, net	37,774	41,749
Loans to students, net of allowances of $5,008 and $3,990	11,075	9,933
Inventories	27,093	17,970
Prepaid expenses and other assets	44,609	38,900
Investments held under securities lending program	220,032	232,556
Total current assets	1,129,822	1,117,386
Noncurrent assets:		
Deposits held by bond trustees	18,625	18,834
Contributions receivable, net	72,666	75,796
Loans to students, net of allowances of $12,262 and $11,414	27,111	28,380
Deferred bond costs	5,606	5,934
Total investment in plant, net of accumulated depreciation	2,426,556	2,279,816
Beneficial interest in perpetual trusts	15,676	15,398
Investments	2,606,418	2,383,850
Total noncurrent assets	5,172,658	4,808,008
Total assets	$ 6,302,480	$ 5,925,394

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
LIABILITIES AND NET ASSETS
JUNE 30, 2006 AND 2005
(in thousands)

	June 30, 2006	June 30, 2005
Current liabilities:		
Accounts payable and other accrued expenses	$ 347,576	$ 350,034
Deferred revenue	165,293	149,776
Long-term debt	47,590	44,702
Present value of annuities payable	4,691	4,362
Accrued postretirement benefits	28,036	26,031
Liability under securities lending program	220,032	232,556
Total current liabilities	813,218	807,461
Noncurrent liabilities:		
Deposits held in custody for others	31,864	28,974
Deferred revenue	841	858
Long-term debt	773,610	804,236
Present value of annuities payable	32,106	30,628
Accrued postretirement benefits	658,909	590,408
Refundable United States Government student loans	33,104	34,740
Other liabilities	117,482	62,740
Total noncurrent liabilities	1,647,916	1,552,584
Total liabilities	2,461,134	2,360,045
Net assets:		
Unrestricted -		
Undesignated	938	928
Designated for specific purposes	1,215,547	1,183,895
Net investment in plant	1,463,639	1,337,788
Total unrestricted	2,680,124	2,522,611
Temporarily restricted	400,361	329,067
Permanently restricted	760,861	713,671
Total net assets	3,841,346	3,565,349
Total liabilities and net assets	$ 6,302,480	$ 5,925,394

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2006
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues and other support:				
Tuition and fees, net of discounts of $87,784	$ 949,774	$ -	$ -	$ 949,774
Commonwealth of Pennsylvania -				
Appropriations	312,026	-	-	312,026
Special contracts	76,085	-	-	76,085
Department of General Services projects	43,776	-	-	43,776
United States Government grants and contracts	381,590	-	-	381,590
Private gifts, grants and contracts	187,748	26,942	41,307	255,997
Endowment income, net	75,178	64,751	10,158	150,087
Other investment income, net	45,626	4,592	197	50,415
Sales and services of educational activities	40,427	-	-	40,427
Recovery of indirect costs	106,975	-	-	106,975
Auxiliary enterprises	272,703	-	-	272,703
Hospital operations	753,704	-	-	753,704
Other sources	18,280	365	276	18,921
Net assets released from restrictions	23,628	(23,628)	-	-
Total revenues and other support	3,287,520	73,022	51,938	3,412,480
Expenses and losses:				
Educational and general -				
Instruction	806,686	-	-	806,686
Research	616,707	-	-	616,707
Public service	74,148	-	-	74,148
Academic support	266,168	-	-	266,168
Student services	113,785	-	-	113,785
Institutional support	229,027	-	-	229,027
Student aid	756	-	-	756
Total educational and general	2,107,277	-	-	2,107,277
Auxiliary enterprises	254,698	-	-	254,698
Hospital operations	719,097	-	-	719,097
Write-offs and disposals of assets	4,563	-	-	4,563
Actuarial adjustment on annuities payable	-	1,728	4,748	6,476
Total expenses and losses	3,085,635	1,728	4,748	3,092,111
Increase in net assets before cumulative effect	201,885	71,294	47,190	320,369
Cumulative effect of adoption of new accounting principle	(44,372)	-	-	(44,372)
Increase in net assets	157,513	71,294	47,190	275,997
Net assets at the beginning of the year	2,522,611	329,067	713,671	3,565,349
Net assets at the end of the year	$ 2,680,124	$ 400,361	$ 760,861	$ 3,841,346

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2005
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues and other support:				
Tuition and fees, net of discounts of $81,517	$ 892,563	$ -	$ -	$ 892,563
Commonwealth of Pennsylvania -				
Appropriations	317,179	-	-	317,179
Special contracts	68,474	-	-	68,474
Department of General Services projects	76,358	-	-	76,358
United States Government grants and contracts	356,649	-	-	356,649
Private gifts, grants and contracts	182,291	18,437	26,248	226,976
Endowment income, net	72,343	61,931	8,545	142,819
Other investment income, net	85,029	6,504	160	91,693
Sales and services of educational activities	41,986	-	-	41,986
Recovery of indirect costs	100,911	-	-	100,911
Auxiliary enterprises	250,579	-	-	250,579
Hospital operations	693,532	-	-	693,532
Other sources	9,411	536	424	10,371
Net assets released from restrictions	25,753	(25,753)	-	-
Total revenues and other support	3,173,058	61,655	35,377	3,270,090
Expenses and losses:				
Educational and general -				
Instruction	760,735	-	-	760,735
Research	579,687	-	-	579,687
Public service	69,686	-	-	69,686
Academic support	254,959	-	-	254,959
Student services	111,348	-	-	111,348
Institutional support	221,907	-	-	221,907
Student aid	720	-	-	720
Total educational and general	1,999,042	-	-	1,999,042
Auxiliary enterprises	230,505	-	-	230,505
Hospital operations	664,689	-	-	664,689
Write-offs and disposals of assets	6,521	-	-	6,521
Actuarial adjustment on annuities payable	-	989	4,705	5,694
Total expenses and losses	2,900,757	989	4,705	2,906,451
Increase in net assets	272,301	60,666	30,672	363,639
Net assets at the beginning of the year	2,250,310	268,401	682,999	3,201,710
Net assets at the end of the year	$ 2,522,611	$ 329,067	$ 713,671	$ 3,565,349

See notes to consolidated financial statements.

THE PENNSYLVANIA STATE UNIVERSITY
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005
(in thousands)

	June 30, 2006	June 30, 2005
Cash flows from operating activities:		
Increase in net assets	$ 275,997	$ 363,639
Adjustments to reconcile change in net assets to net cash provided by operating activities -		
Actuarial adjustment on annuities payable	6,476	5,694
Contributions restricted for long-term investment	(72,616)	(55,569)
Interest and dividends restricted for long-term investment	(17,177)	(11,529)
Net realized and unrealized gains on long-term investments	(99,805)	(132,483)
Depreciation and amortization expense	168,340	158,211
Write-offs and disposals of assets	5,227	6,944
Contributions of land, buildings and equipment	(9,323)	(3,283)
Buildings and equipment provided by Pennsylvania Department of General Services	(14,027)	(54,428)
Contribution to government student loan funds	254	257
Provision for bad debts	15,310	15,047
Cumulative effect of adoption of new accounting principle	44,372	-
Increase in deposits	(1,713)	(588)
Increase in receivables	(31,688)	(7,811)
Increase in inventories	(9,123)	(522)
Increase in prepaid expenses and other assets	(11,644)	(6,906)
Increase in accounts payable and other accrued expenses	4,044	31,315
Increase in deferred revenue	15,500	7,736
Increase in accrued postretirement benefits	70,507	58,343
Net cash provided by operating activities	338,911	374,067
Cash flows from investing activities:		
Purchase of land, buildings and equipment	(285,405)	(311,767)
Decrease/(increase) in deposits held by bond trustees	209	(8,431)
Advances on student loans	(14,177)	(13,108)
Collections on student loans	11,434	10,113
Change in collateral deposits under securities lending program	12,524	(232,556)
Change in obligation to return collateral under securities lending program	(12,524)	232,556
Purchase of investments	(2,771,709)	(1,849,904)
Proceeds from sale of investments	2,639,922	1,786,739
Net cash used by investing activities	(419,726)	(386,358)
Cash flows from financing activities:		
Contributions restricted for long-term investment	72,616	55,569
Interest and dividends restricted for long-term investment	17,177	11,529
Payments of annuity obligations	(4,732)	(4,362)
Proceeds from issuance of bonds	4,820	119,528
Principal payments on notes, bonds and capital leases	(33,411)	(45,601)
Proceeds related to government student loan funds, net of collection costs	584	1,079
Net cash provided by financing activities	57,054	137,742
Net (decrease) increase in cash and cash equivalents	(23,761)	125,451
Cash and cash equivalents at the beginning of the year	489,278	363,827
Cash and cash equivalents at the end of the year	$ 465,517	$ 489,278

See notes to consolidated financial statements.

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 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.

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 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 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 TMHSMC 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.

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, 2006 and 2005. 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, because approximately 99% of the total outstanding loans to students as of June 30, 2006 and 2005 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:

	2006	2005
Interest paid	$ 34,326,000	$ 31,293,000
Non-cash acquisitions of land, buildings and equipment	19,997,000	63,828,000

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 $36,719,000 and $45,889,000 of cash and cash equivalents held in operating investment portfolios at June 30, 2006 and 2005, 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 statement 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.

Due to the level of risk associated with certain investments, it is reasonably possible that changes in the values of investments 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 $15,676,000 and $15,398,000 held by outside trustees at June 30, 2006 and 2005, 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:

	2006	2005
Land	$ 87,447,000	$ 84,954,000
Buildings	2,986,479,000	2,774,881,000
Improvements other than buildings	398,502,000	363,872,000
Equipment	782,585,000	742,019,000
Total plant	4,255,013,000	3,965,726,000
Less accumulated depreciation	(1,828,457,000)	(1,685,910,000)
Total investment in plant	$ 2,426,556,000	$ 2,279,816,000

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. As a result of this process, the University recorded the cumulative effect of conditional asset retirement obligations totaling $44,372,000 and the resulting liability is included in other liabilities within the consolidated balance sheet. Proforma amounts are shown as follows.

For the Year Ended June 30	2006	2005
Excess of revenues over expenses (as reported)	$ 275,997,000	$ 363,639,000
Add: FIN 47 cumulative effect	44,372,000	-
Less: FIN 47 expense	(2,264,000)	(2,152,000)
Proforma excess of revenues over expenses	$ 318,105,000	$ 361,487,000

The liability related to conditional asset obligations at June 30, 2006 and 2005 and July 1, 2004 would have been $44,798,000, $42,564,000 and $40,441,000, respectively, assuming FIN 47 had been applied as of July 1, 2004.

3. INVESTMENTS

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

	2006	2005
Money markets	$ 243,016,000	$ 144,353,000
Fixed income:		
U.S. government/agency	482,256,000	608,600,000
U.S. corporate	312,048,000	347,879,000
Foreign	59,013,000	42,076,000
Common stock	911,643,000	861,679,000
Other investments	635,161,000	425,152,000
Investments held under securities lending program	220,032,000	232,556,000
Total	$2,863,169,000	$2,662,295,000

Common stock investments are comprised of domestic and foreign equities. Other investments consist primarily of interests in real estate, private equity, 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, 2006:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Dividends and interest	$ 84,869,000	$ 3,376,000	$ 9,756,000	$ 98,001,000
Net realized gains, including endowment spending	45,549,000	27,618,000	599,000	73,766,000
Net unrealized gains/(losses)	(9,614,000)	38,349,000	-	28,735,000
Total returns	$ 120,804,000	$ 69,343,000	$10,355,000	$ 200,502,000

The following schedule summarizes the investment return and its classification in the statement of activities for the year ended June 30, 2005:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Dividends and interest	$ 84,000,000	$ 862,000	$ 8,745,000	$ 93,607,000
Net realized gains/(losses), including endowment spending	40,338,000	33,598,000	(40,000)	73,896,000
Net unrealized gains	33,034,000	33,975,000	-	67,009,000
Total returns	$ 157,372,000	$ 68,435,000	$ 8,705,000	$ 234,512,000

In the management of investments, the University authorizes certain of its investment managers to purchase derivative securities. Derivatives may be used to attain a desired market position; however, derivatives are not used for speculative purposes. 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 comprise approximately 3.0% and 1.7% of total investments at June 30, 2006 and 2005, respectively.

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, 2006 and 2005, the University held $220,032,000 and $232,556,000, 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 statement of financial position. The securities on loan had an estimated fair value of $216,174,000 and $228,115,000 at June 30, 2006 and 2005, 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 $1,303,476,000 and $1,157,486,000 at June 30, 2006 and 2005, 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:

	2006	2005
Market value per unit	$ 28.28	$ 26.07
Annual net gains per unit	$ 2.21	$ 1.67
Average annual earnings per unit, exclusive of gains	$ 0.85	$ 1.15

5. CONTRIBUTIONS RECEIVABLE

Contributions receivable are summarized as follows as of June 30:

	2006	2005
In one year or less	$ 45,258,000	$ 53,001,000
Between one year and five years	47,666,000	51,461,000
More than five years	70,397,000	65,184,000
	163,321,000	169,646,000
Less allowance	(7,196,000)	(5,360,000)
Less discount	(45,685,000)	(46,741,000)
Contributions receivable, net	$ 110,440,000	$ 117,545,000

At June 30, 2006 and 2005, the University has received bequest intentions and certain other conditional promises to give of $14,160,000 and $15,254,000, respectively. These intentions and conditional promises to give are not included in the consolidated financial statements.

6. BONDS AND NOTE PAYABLE

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

- $4,700,000 of Pennsylvania Higher Education Facilities Authority 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 costs issuance. Principal payments are due annually, beginning September 2006, in amounts ranging from $50,000 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 3.50% to 5.125% and are subject to sinking fund redemption beginning September 2021 and early redemption provisions, at the option of the University, beginning September 2016.

- $98,175,000 of general obligation bonds issued in January 2005 for the purpose of funding various construction projects. Principal payments are due annually, beginning September 2006, in amounts ranging from $1,620,000 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.

- $5,410,000 of Pennsylvania Higher Education 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 $195,000 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 2.50% 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.

- $60,980,000 of general obligation bonds issued in April 2004 for the purpose of funding various construction projects. Principal payments are due annually in amounts ranging from $1,050,000 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 2.50% 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.

- $28,130,000 of general obligation bonds issued in March 2003 (2003 Refunding Bonds) 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 $1,870,000 to $2,970,000 through March 2018. The bonds pay interest at rates ranging from 2.20% to 5.25% and are subject to early redemption provisions, at the option of the University, beginning March 2013.

- $6,250,000 of Pennsylvania Higher Education 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 $285,000 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 3.25% to 5.00% and are subject to sinking fund redemption beginning March 2018 and early redemption provisions, at the option of the University, beginning March 2011.

- $100,000,000 of 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. 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 3.96% 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 a standby bond purchase agreement with a bank to provide liquidity in case of tender. The principal amount of the bonds is due March 2032. The bonds are not subject to sinking fund redemption; however, the University has the option to redeem the bonds prior to their scheduled maturity.

- $140,760,000 of general obligation bonds issued in May 2002 (2002 Refunding Bonds) 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 4.73% to 5.25%. The bonds are not subject to redemption prior to maturity.

- $42,235,000 of general obligation bonds issued in December 2001 (2001 Refunding Bonds) 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 $7,645,000 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 optional redemption prior to maturity.

- $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 (such rates are generally determined on a market basis). The bonds currently pay interest at 3.96% 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.

- $96,225,000 (Series A - $86,750,000; Series B - $9,475,000) of general obligation bonds issued in December 1997 for the purpose of funding various construction projects and for refunding the Series 1992B Bonds. Principal payments are due annually, in amounts ranging from $2,880,000 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.

- $15,555,000 of 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, beginning in 2006, in amounts ranging from $330,000 to $1,855,000 through January 2025. The bonds pay interest at rates ranging from 2.50% to 5.00%.

- $9,565,000 of 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 payments are due annually in amounts ranging from $3,070,000 to $3,315,000 through November 2008. The bonds pay interest at rates ranging from 1.90% to 4.625%.

- $30,325,000 of 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 $330,000 to $2,775,000 through May 2032. The bonds pay interest at rates ranging from 3.80% to 5.25%.

- $39,370,000 of Lycoming County Authority College Revenue Bonds issued by Penn College in December 2000 (Series 2000 Bonds) 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%.

- $11,530,000 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 in amounts ranging from $230,000 to $5,010,000 through July 2018. The bonds pay interest at rates ranging from 4.85% to 5.25%. The 1997 Series Bonds were partially refunded by the 2000 Series Bonds at a par amounting to $4,235,000.

- $11,565,000 of Lycoming County Authority College Revenue Bonds issued by Penn College in 1993 for the purpose of undertaking a series of capital improvement projects. Principal payments are due annually in amounts ranging from $450,000 to $1,302,000 from November 2009 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 and thereafter are summarized as follows:

Year	Annual Installments
2007	$ 33,480,000
2008	35,355,000
2009	37,025,000
2010	35,475,000
2011	35,310,000
Thereafter	599,130,000

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, 2006, the carrying value and estimated fair value of the University's bonds payable, including issuance premiums, are $793,174,000 and $791,870,000, respectively. At June 30, 2005, the carrying value and estimated fair value of the University's bonds payable, including issuance premiums, were $819,676,000 and $837,808,000, respectively. Certain bond issues have associated issuance premiums, these issuance premiums total $17,399,000 and $18,633,000 at June 30, 2006 and 2005, 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.

A $10,000,000 demand note payable bearing interest at variable rates (4.95% at June 30, 2006) is included in long-term debt in the statements of financial position.

7. 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 $27,122,000 and $28,312,000 at June 30, 2006 and 2005, 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, 2006 are as follows:

Year	
2007	$ 2,756,000
2008	2,588,000
2009	2,273,000
2010	2,067,000
2011	1,840,000
Thereafter	17,055,000
Total minimum lease payments	28,579,000
Less imputed interest	(10,553,000)
Present value of net minimum lease payments	$ 18,026,000

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 $1,202,000 and $1,091,000 in investments at June 30, 2006 and 2005, 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. 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, 2006, the University recorded expenses of $22,075,000 for leased equipment and $13,216,000 for leased building space. During the year ended June 30, 2005, the University recorded expenses of $18,654,000 for leased equipment and $11,000,000 for leased building space.

Future minimum lease payments under operating leases as of June 30, 2006 are as follows:

Year	
2007	$ 16,039,000
2008	11,233,000
2009	7,340,000
2010	4,872,000
2011	3,600,000
Thereafter	25,548,000
Total minimum lease payments	$ 68,632,000

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 ($7,390,000 and $4,642,000 for the years ended June 30, 2006 and 2005, respectively). The University's total cost for retirement benefits, included in expenses, is $84,871,000 and $78,356,000 for the years ended June 30, 2006 and 2005, respectively.

9. 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, 2006, the monthly rates ranged from $7 to $328 depending on age and dependent coverage options selected.

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:

	2006	2005
Benefit obligation at beginning of year	$ 805,034,000	$ 748,170,000
Service cost	40,118,000	32,012,000
Interest cost	46,604,000	45,422,000
Actuarial loss	3,877,000	5,559,000
Benefits paid	(28,142,000)	(26,129,000)
Plan amendment	(44,939,000)	-
Benefit obligation at end of year	$ 822,552,000	$ 805,034,000

Change in plan assets:

	2006	2005
Fair value of plan assets at beginning of year	$ -	$ -
Employer contributions	28,142,000	26,129,000
Benefits paid	(28,142,000)	(26,129,000)
Fair value of plan assets at end of year	$ -	$ -
Funded status	$ (822,552,000)	$ (805,034,000)
Unrecognized prior service cost	(41,106,000)	266,000
Unrecognized net actuarial loss	176,713,000	188,329,000
Accrued postretirement benefit expense	$ (686,945,000)	$ (616,439,000)

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

	2006	2005
Service cost	$ 40,118,000	$ 32,012,000
Interest cost	46,604,000	45,422,000
Amortization of prior service cost	(3,567,000)	48,000
Amortization of unrecognized net loss	15,494,000	6,989,000
Net periodic postretirement cost	$ 98,649,000	$ 84,471,000

The assumed healthcare cost trend rate used in measuring the accumulated postretirement benefit obligation was 10.00% and 8.50% for the 2005-2006 and 2004-2005 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% and 5.25% for the years ended June 30, 2006 and 2005, respectively.

If the healthcare cost trend rate assumptions were increased by 1% in each year, the accumulated postretirement benefit obligation would be increased by $137,520,000 and $153,202,000 as of June 30, 2006 and 2005, 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 $19,146,000 and $16,952,000 as of June 30, 2006 and 2005, respectively. If the healthcare cost trend rate assumptions were decreased by 1% in each year, the accumulated postretirement benefit obligation would be decreased by $110,796,000 and $120,541,000 as of June 30, 2006 and 2005, 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 $14,813,000 and $13,081,000 as of June 30, 2006 and 2005, respectively.

The postretirement benefits expected to be paid in each year for 2007–2011 are $27,651,000, $30,259,000, $32,831,000, $35,691,000 and $38,416,000, respectively. The benefits expected to be paid in the five years from 2012-2016 are $393,858,000.

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.

The plan amendment included in 2006 reflects changes in the premium cost sharing contributions for Medicare-eligible retirees.

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

Contractual Obligations

The University has contractual obligations for the construction of new buildings and for additions to existing buildings in the amount of $526,550,000 of which $441,631,000 has been paid or accrued as of June 30, 2006. 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 $142,857,000 as of June 30, 2006 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 $17,976,000 and $11,332,000 as of June 30, 2006 and 2005, 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 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 $71,151,000 and $70,896,000 is recorded as of June 30, 2006 and 2005, 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 $15,419,000 and $14,463,000 at June 30, 2006 and 2005, 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 insurance coverage for excess obligations over $600,000 per incident. An estimate of the self-insured workers' compensation claims liability in the amount of $7,371,000 and $6,734,000 is recorded as of June 30, 2006 and 2005, respectively. The University has established a trust fund, in the amount of $9,348,000 and $8,937,000 at June 30, 2006 and June 30, 2005, 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 year, respectively. The University and TMSHMC provide for reported claims and claims incurred but not reported.

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 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.

THE PENNSYLVANIA STATE UNIVERSITY

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as of September 29, 2006

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