PENNSYLVANIA'S STATE SYSTEM OF HIGHER EDUCATION

Pennsylvania's
STATE SYSTEM
of Higher Education

FINANCIAL STATEMENTS
JUNE 30, 2014

Pennsylvania's State System of Higher Education
Financial Statements
June 30, 2014

Table of Contents

INDEPENDENT AUDITORS' REPORT

Board of Governors
Pennsylvania State System of Higher Education
Harrisburg, Pennsylvania

Report on the Financial Statements

We have audited the accompanying financial statements of the business type activities and the aggregate discretely presented component units of the Pennsylvania State System of Higher Education ("the State System"), a component unit of the Commonwealth of Pennsylvania, as of and for the years ended June 30, 2014 and 2013, and the related notes to the financial statements, which collectively comprise the State System's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of the discretely presented component units, which represent 100% percent, 100% percent, and 100% percent, respectively, of the assets, net assets, and revenues of the discretely presented component units. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for the discretely presented component units, is based solely on the reports of the other auditors. 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the business type activities and the aggregate discretely presented component units of the State System as of June 30, 2014 and 2013, and the respective changes in financial position and, where applicable, cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note (1) to the financial statements, the State System implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 65 – *Items Previously Reported as Assets and Liabilities* for the year ended June 30, 2014, which represents a change in accounting principle. As of July 1, 2012, the State System's net position was restated to reflect the impact of adoption. A summary of the restatement is presented in Note (1). Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3-13 and the schedules of funding progress for OPEB on page 36 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

CliftonLarsonAllen LLP

CliftonLarsonAllen LLP

Harrisburg, Pennsylvania
September 26, 2014

MANAGEMENT'S DISCUSSION AND ANALYSIS

(Unaudited)

As the public universities of the Commonwealth of Pennsylvania (Commonwealth), the 14 universities of Pennsylvania's State System of Higher Education (State System) are charged with providing high quality education at the lowest possible cost to the students. With over 110,000 students enrolled, the State System is the state's largest higher education provider. Its 14 universities offer the lowest-cost four-year baccalaureate degree programs in the state in more than 120 areas of study. The universities function independently, but being part of the State System enables them to share resources and benefit from economies of scale.

The State System financial statements comprise:

- Bloomsburg University of Pennsylvania
- California University of Pennsylvania
- Cheyney University of Pennsylvania
- Clarion University of Pennsylvania
- East Stroudsburg University of Pennsylvania
- Edinboro University of Pennsylvania
- Indiana University of Pennsylvania
- Kutztown University of Pennsylvania
- Lock Haven University of Pennsylvania
- Mansfield University of Pennsylvania
- Millersville University of Pennsylvania
- Shippensburg University of Pennsylvania
- Slippery Rock University of Pennsylvania
- West Chester University of Pennsylvania
- Office of the Chancellor

Following is an overview of the State System's financial activities for the year ended June 30, 2014, as compared to the year ended June 30, 2013.

FINANCIAL HIGHLIGHTS

In fiscal year 2013/14, the State System received $412.8 million in General Fund **appropriations** from the Commonwealth, the same amount as received in fiscal years 2012/13 and 2011/12. This also is the same level of funding the State System received in fiscal year 1997/98—16 years ago.

The State System received a $13.6 million Realty Transfer Tax allocation from the Commonwealth's **Key '93** (Keystone Recreation, Park and Conservation) Fund, an increase of $1.9 million, or 16%, from fiscal year 2012/13. With the exception of fiscal years 2010/11 and 2009/10, when no funding was provided, Key '93 funds have provided a consistent revenue stream for university deferred maintenance projects since 1993.

The State System received $65 million in **Commonwealth capital funding**, primarily for renovation or replacement of existing educational and general buildings. With the exception of fiscal years 2010/11 and 2009/10, when the Commonwealth's capital funding for the State System was $130 million each year, the State System has received $65 million annually in Commonwealth capital funding since fiscal year 2000/01. Annual funding is expected to remain at $65 million for the foreseeable future. The capital appropriations reflected in these statements represent the furnishings and equipment for the Commonwealth-funded construction projects and total $14.4 million and $14.8 million in fiscal years 2013/14 and 2012/13, respectively.

As part of its continuing commitment to reward the universities for demonstrated success and continued improvement in student achievement, university excellence, and operational efficiency, the State System's Board of Governors (Board) allocated $37.0 million of the general appropriation for **performance funding** in fiscal year 2013/14, approximately 1% more than the $36.6 million allocated in fiscal year 2012/13. Performance funding allocated in fiscal year 2011/12 was $35.9 million.

Fall 2013 enrollment was 112,028, a decrease of 2,443 students, or 2.1%, from fall 2012. This is the third year in a row that the State System has experienced an **enrollment decline**. Fall 2012 enrollment was 114,471, a decrease of 3,753 students, or 3.2%, from the fall 2011 enrollment of 118,224. Fall 2011 was the first year enrollment had declined since 1999. Despite these three years of decline, the State System's fall enrollment has increased 38% since fall of 1983, which was the first year of operation as a System.

Of the 112,028 **students** in the fall 2013 enrollment, 95,494 (85%) were full-time and 16,534 (15%) were part-time students; 98,396 (88%) were undergraduate and 13,632 (12%) were graduate students. These percentages of full- and part-time, graduate and undergraduate, are approximately the same as in fall 2012.

In academic year 2012/13, the State System awarded 25,632 **degrees**, comprising 19,635 bachelor's degrees; 5,416 master's degrees; 175 doctoral degrees; and 406 associate's degrees. This compares to 26,203 degrees awarded in academic year 2011/12 and 22,870 degrees awarded in academic year 2010/11.

The Board approved an annual full-time **tuition rate increase** of $194 (3%) for undergraduate resident students in fiscal year 2013/14. This compares to an increase of $188 (3%) in fiscal year 2012/13. The State System's 2013/14 annual tuition rate of $6,622 for full-time, resident, undergraduate students is the lowest of baccalaureate degree programs in the state.

The Board approved **new tuition rates for resident graduate students and all nonresident students**. The resident graduate tuition rate in 2013/14 was $442 per credit, an increase of $13. Nonresident graduate tuition increased by $19 per credit to $663. Full-time, undergraduate tuition for nonresident students ranged from $9,934 to $16,556, depending on a variety of factors, including the university and program in which a student enrolled, academic preparation, and state of residency. All of the increases average approximately 3%.

The Board approved a $5 increase to the **tuition technology fee (**$368 annually) for full-time resident undergraduate students and an $8 increase ($558 annually) for full-time nonresident undergraduate students. All funds raised by the technology fee are used to directly benefit student learning. Universities have used the funds to install new computer labs and to design multimedia classrooms, among other projects.

Mandatory student fees set by the universities increased, on average, by 3.2%. These increases, combined with the increase in tuition and reduction in enrollment, resulted in tuition and mandatory fee revenue (before discounts) of $1.06 billion, a 4.2% increase over fiscal year 2012/13. The average increase in mandatory student fees was 0.4% in fiscal year 2012/13 over the prior year.

Auxiliary revenue from **room and board fees** (excluding privatized housing revenue recorded by affiliates) was $266.8 million, an increase of $0.3 million, or 1.2%, over fiscal year 2012/13. This compares to a fiscal year 2012/13 increase of 7.9% in room and board revenue over the prior fiscal year.

The State System's **average price of attendance** (tuition, mandatory fees, room, and board) of $18,028 in 2013/14 was $363 below the average among all four-year public universities in the United States and $2,228 below the average in the Middle States region (Delaware, Maryland, New Jersey, New York, Pennsylvania, and Washington, D.C.), according to the latest College Board survey.

The State System purchased $119.9 million in **capital assets** in fiscal year 2013/14, including $91.5 million to build or improve academic and auxiliary facilities across all 14 universities.

During fiscal year 2013/14, the State System issued Series AO bonds, totaling $30.9 million, to undertake various university capital projects and issued Series AP bonds, totaling $46.1 million, to current refund Series Z and AA bonds. $65.6 million of bond principal and $44.0 million of interest were paid, and $51.4 million of bonds were redeemed, bringing the total outstanding **bond debt** to $859.9 million at June 30, 2014.

In April 2014, Moody's Investors Service, Inc., reaffirmed the State System's **Aa3 bond rating**, but downgraded its current outlook from *stable* to *negative*.

THE FINANCIAL STATEMENTS

Balance Sheet

The *Balance Sheet* reports the balances of the assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position of the State System as of the end of the fiscal year.

The Governmental Accounting Standards Board, or GASB, issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, effective for the year ended June 30, 2013, adding new balance sheet classifications and changing the terminology of other balance sheet classifications:

- *Assets* include cash; investments reported at market value; the value of outstanding receivables due from students and other parties; and land, buildings, and equipment reported at cost, less accumulated depreciation.

- *Deferred Outflows of Resources*, which is defined as a consumption of net position that applies to future periods, reports the deferred loss on bond defeasance.

- *Liabilities* include payments due to vendors and students; the balance of bonds payable; and liabilities such as workers' compensation (the State System is self-insured), compensated absences (the value of sick and annual leave earned by employees), and postretirement benefits (health and tuition benefits expected to be paid to certain current and future retirees).

- *Deferred Inflows of Resources*, which is defined as an acquisition of net position that applies to future periods, reports the deferred gain on bond defeasance.

- *Net Position*, which was previously referred to as *Net Assets* or *Fund Balance*, is the sum of Assets plus Deferred Outflows of Resources less Liabilities less Deferred Inflows of Resources.

GASB believes that the new classifications and terminology improve financial reporting and provide clarity to the financial statements.

Statement of Revenues, Expenses, and Changes in Net Position

The *Statement of Revenues, Expenses, and Changes in Net Position* reports the revenues earned and the expenses incurred during the fiscal year. The result is reported as an increase or decrease in net position.

In accordance with GASB requirements, the State System has classified revenues and expenses as either operating or nonoperating. GASB has determined that all public colleges' and universities' **state appropriations are nonoperating revenues**. In addition, GASB requires classification of gifts, Pell grants, investment income and expenses, unrealized gains and losses on investments, interest expense, and losses on disposals of assets as nonoperating. The State System classifies all of its remaining activities as operating.

GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, required a restatement of the June 30, 2013, *Statement of Revenues, Expenses, and Changes in Net Position*, to reflect the change in reporting bond issuance costs from an asset that is amortized over the life of the bond to an expense in the year incurred.

Statement of Cash Flows

The *Statement of Cash Flows* provides information about the State System's cash receipts and cash payments. It may be used to determine the State System's ability to generate future net cash flows and meet its obligations as they come due and its need for external financing.

Net Position

In accordance with GASB requirements, the State System reports three components of net position:

- *Net investment in capital assets* is the cost of land, buildings, improvements, equipment, furnishings, and library books, net of accumulated depreciation, less any associated debt (primarily bonds payable). This balance is not available for the State System's use in ongoing operations, since the underlying assets would have to be sold in order to use the balance to pay current or long-term obligations. The Commonwealth prohibits the State System from selling university land and buildings without prior approval.

- *Restricted* net position represents the portion of balances of funds received from the Commonwealth, donors, or grantors who have placed restrictions on the purpose for which the funds must be spent. *Nonexpendable* restricted net position represents corpuses of endowments and similar arrangements in which only the associated investment income can be spent. *Expendable* restricted net position represents the portion of restricted funds that is available for expenditure as long as any external purpose and time restrictions are met.

- *Unrestricted* net position includes funds that the Board or university presidents have designated for specific purposes, auxiliary funds, and all other funds not appropriately classified as restricted or invested in capital assets.

  Unrestricted net position reflects two unfunded liabilities:

  - The liability for **postretirement benefits** for employees who participate in the State System health care plan increased by $73.4 million to $1.01 billion for the year ended June 30, 2014. Because this liability is expected to be realized gradually over time, and because of its size, the universities fund it only as it becomes due.

  - The liability for **compensated absences** increased by $4.8 million to $114.7 million for the year ended June 30, 2014. Similar to the postretirement benefits liability, cash payouts to employees upon termination or retirement for annual and sick leave balances are expected to be realized gradually over time.

Overall, net position decreased by $52.8 million in fiscal year 2013/14, compared to a decrease of $13.9 million *(restated)* in fiscal year 2012/13.

Following is a summary of the balance sheet at June 30, 2014, 2013, and 2012.

(in millions)

Balance Sheet

	June 30, 2014	**Change from Prior Year**	*Restated* **June 30, 2013**	**Change from Prior Year**	*Restated* **June 30, 2012**	**Change from Prior Year**
Assets						
Cash and investments	$1,363.1	0.0%	$1,362.8	1.7%	$1,340.3	11.7%
Capital assets, net	1,616.8	(0.8%)	1,629.6	0.4%	1,623.4	4.6%
Other assets and deferred outflows	184.8	5.1%	175.9	(5.6%)	186.4	(11.0%)
Total assets and deferred outflows	$3,164.7	(0.1%)	$3,168.3	0.6%	$3,150.1	6.4%
Liabilities						
Workers' compensation	$21.7	1.9%	$21.3	7.6%	$19.8	4.2%
Compensated absences	114.7	4.4%	109.9	1.6%	108.2	6.3%
Postretirement benefits	1,007.1	7.9%	933.7	8.0%	864.4	9.2%
Bonds payable	859.9	(4.4%)	899.8	(4.4%)	941.7	6.4%
Other liabilities and deferred inflows	422.3	2.5%	411.8	0.4%	410.3	(2.9%)
Total liabilities and deferred inflows	2,425.7	2.1%	2,376.5	1.4%	2,344.4	5.6%
Net Position						
Net investment in capital assets	684.4	5.7%	647.7	5.4%	614.4	2.1%
Restricted	103.3	11.7%	92.5	7.3%	86.2	12.7%
Unrestricted	(48.7)	(194.4%)	51.6	(50.9%)	105.1	66.8%
Total net position	739.0	(6.7%)	791.8	(1.7%)	805.7	8.7%
Total liabilities, deferred inflows, and net position	$3,164.7	(0.1%)	$3,168.3	0.6%	$3,150.1	6.4%

Revenues and Expenses
Overall, fiscal year 2013/14 **operating revenues** increased by 1.1% from the prior fiscal year. Nonoperating revenues increased slightly by 0.1%. **Investment income** (before investment expenses) for fiscal year 2013/14 was $26.2 million. This represents an increase of $5.8 million from the prior year. The increase is due in part to the slowing of the rate of decline in interest rates during the course of the fiscal year and to the increase in the average monthly operating capital, which was $43 million, or 3.5%, higher than in the previous fiscal year. The increase in operating capital can be attributed to the universities' conservative budgeting and spending practices during this financially challenging time.

Universities spent $721.0 million on **instruction**, or 36.5% of total operating expenses, in fiscal year 2013/14. This represents an increase of $16.5 million, or 2.3%, over fiscal year 2012/13.

Financial aid to students in the form of waivers and scholarships was $297.2 million in fiscal year 2013/14, an increase of $10.3 million from the previous year. In accordance with a formula prescribed by the National Association of College and University Business Officers (NACUBO), the State System reported $219.8 million of financial aid as *scholarship discounts and allowances* (netted against tuition and fees) and $75.6 million as *student aid* expense in fiscal year 2013/14. $1.8 million of financial aid was reported in Auxiliary enterprises. Following is the breakdown of scholarship discounts and allowances and waivers in fiscal years 2013/14 and 2012/13.

(in millions)

Student Financial Aid

	2013/14	**2012/13**
Federal Pell grants	$143.7	$140.6
Other federal aid	5.3	6.8
State financial aid including PHEAA grants	95.4	89.6
Local government financial aid	1.7	1.7
Scholarships from endowments and restricted gifts and grants	15.5	13.0
Unrestricted scholarships and fellowships	13.9	12.3
Tuition and fee waivers	20.4	21.6
Housing and dining waivers	1.3	1.3
Total	$297.2	$286.9

Interest expense on capital asset-related debt was $36.9 million, a decrease of $1.1 million over fiscal year 2012/13.

Salaries and benefits totaled $1.3 billion in fiscal year 2013/14. Compared to fiscal year 2012/13, salary and wage expenses increased by $10.1 million, or 1.2%, while benefit expenses increased by $30.9 million, or 7.2%, for an overall increase of $41.0 million.

- Employer share of **employee health care** costs increased $9.9 million over fiscal year 2012/13, for a total increase of 8.5%. This follows an increase of 2.9% ($3.3 million) and a decrease of 6.1% ($7.4 million) in fiscal years 2012/13 and 2011/12, respectively, over the prior fiscal years.

- Employer share of **annuitant health care** costs increased $8.3 million over fiscal year 2012/13, for a total increase of 6.0%. This follows consecutive increases of 2.2% ($3.0 million) and 6.9% ($8.7 million) in fiscal years 2012/13 and 2011/12, respectively, over the prior fiscal years. The increases are caused not only by the increase in health care costs, but also by the increase in the number of retirees.

- Employer contributions to **SERS** (Commonwealth of Pennsylvania State Employees' Retirement System), which is a defined benefits pension plan, increased $13.0 million over fiscal year 2012/13, for a total increase of 42.6%. This follows consecutive increases of 48.1% ($9.9 million) and 58.5% ($7.6 million) in fiscal years 2012/13 and 2011/12, respectively, over the prior fiscal years. The steep increases were instituted by SERS to fund its unfunded actuarial accrued liability, which was $17.9 billion at December 31, 2013, up from $17.8 billion at December 31, 2012. Approximately 40% of the State System's employees are enrolled in SERS.

- Employer contributions to **PSERS** (Public School Employees' Retirement System), which is a defined benefits pension plan, increased 39.3% over fiscal year 2012/13, for a total increase of $1.1 million. This follows consecutive increases of 55.6% ($1.0 million) and 20.0% ($0.3 million) in fiscal years 2012/13 and 2011/12, respectively, over the prior fiscal years. The steep increases were instituted by PSERS to fund its unfunded actuarial accrued liability, which was $29.5 billion at June 30, 2013, up from $26.5 billion at June 30, 2012. Since only approximately 7% of the State System's employees are enrolled in PSERS, the impact of contribution rate increases from PSERS is far less than the impact from SERS.

- Employer contributions to the **ARP** (Alternate Retirement Plan), which is a defined contribution plan, increased 1.9% over fiscal year 2012/13, for a total increase of $0.8 million. This follows an increase of 2.6% ($1.1 million) and a decrease of 2.1% ($0.9 million) in fiscal years 2012/13 and 2011/12, respectively, over the prior fiscal years. The changes in annual contributions are attributed to fluctuating employee participation. The employer contribution rate (9.29%) has been the same since the plan's inception. Since the ARP is a defined contribution plan, the State System has no liabilities related to future benefits. Approximately 49% of the State System's employees are enrolled in the ARP.

- The total cost for **all other employee benefits**, such as Social Security and workers' compensation, decreased by a total of $2.2 million, or 2.3% less than fiscal year 2012/13, compared to an increase of $1.5 million in fiscal year 2012/13, or 1.6%, over fiscal year 2011/12.

Following are summaries of salaries, wages, and benefits expenses for the years ending June 30, 2014, 2013, and 2012.

(in millions)

Salaries, Wages, and Benefits

	June 30, 2014	Change from Prior Year	June 30, 2013	Change from Prior Year	June 30, 2012	Change from Prior Year
Salaries and wages	$879.5	1.2%	$869.4	1.8%	$853.9	(2.7%)
Benefits						
Employee health care	117.9	8.6%	108.6	3.6%	104.8	(6.9%)
Health & Welfare Fund	8.9	7.2%	8.3	(5.7%)	8.8	4.8%
Annuitant health care	146.2	6.0%	137.9	2.2%	134.9	6.9%
SERS	43.5	42.6%	30.5	48.1%	20.6	58.5%
PSERS	3.9	39.3%	2.8	55.6%	1.8	20.0%
Alternative Retirement Plan (ARP)	43.9	1.9%	43.1	2.6%	42.0	(2.1%)
Other benefits	94.6	(2.3%)	96.8	1.6%	95.3	(2.4%)
Total benefits	458.9	7.2%	428.0	4.9%	408.2	1.5%
Total salaries, wages, and benefits	$1,338.4	3.2%	$1,297.4	2.8%	$1,262.1	(1.4%)

Following are summaries of revenues and expenses for the years ending June 30, 2014, 2013, and 2012.

(in millions)

Revenues and Gains

	June 30, 2014	Change from Prior Year	June 30, 2013	Change from Prior Year	June 30, 2012	Change from Prior Year
Operating revenues						
Tuition and fees, net	$809.3	0.6%	$804.2	2.3%	$786.4	8.7%
Grants and contracts	160.8	1.8%	157.9	(9.8%)	175.0	5.2%
Auxiliary enterprises, net	331.4	(0.5%)	332.9	1.8%	327.1	2.5%
Other	53.2	19.6%	44.5	(21.5%)	56.7	38.6%
Total operating revenues	1,354.7	1.1%	1,339.5	(0.4%)	1,345.2	7.6%
Nonoperating revenues and gains						
State appropriations	427.1	(0.1%)	427.6	1.2%	422.5	(16.3%)
Investment income, net	26.2	28.4%	20.4	(16.7%)	24.5	2.1%
Unrealized gain on investment	-	-	-	(100.0%)	11.7	91.8%
Gifts, nonoperating grants, and other	167.4	(2.6%)	171.8	(1.5%)	174.4	(2.1%)
Total nonoperating revenues and gains	620.7	0.1%	619.8	(2.1%)	633.1	(11.2%)
Total revenues and gains	$1,975.4	0.8%	$1,959.3	(1.0%)	$1,978.3	0.8%

(in millions)

Expenses and Losses

	June 30, 2014	Change from Prior Year	June 30, 2013	Change from Prior Year	June 30, 2012	Change from Prior Year
Operating expenses						
Instruction	$721.0	2.3%	$704.5	3.1%	$683.4	(1.9%)
Research	5.1	(5.6%)	5.4	(18.2%)	6.6	(7.0%)
Public service	37.5	9.6%	34.2	1.2%	33.8	(5.1%)
Academic support	171.9	0.6%	170.8	7.5%	158.9	(0.1%)
Student services	176.6	3.7%	170.3	2.4%	166.3	1.0%
Institutional support	264.0	2.3%	258.1	2.7%	251.4	0.7%
Operations and maintenance of plant	152.3	6.4%	143.2	4.4%	137.1	(2.3%)
Depreciation	120.2	0.6%	119.5	5.6%	113.2	4.6%
Student aid	75.6	1.5%	74.5	(2.7%)	76.6	(3.8%)
Auxiliary enterprises	251.8	3.5%	243.3	3.3%	235.5	1.9%
Total operating expenses	1,976.0	2.7%	1,923.8	3.3%	1,862.8	(0.5%)
Other expenses and losses						
Interest expense on capital asset-related debt	36.9	(2.6%)	37.9	(8.9%)	48.6	33.5%
Loss on disposal of assets	12.1	92.1%	6.3	173.9%	2.3	283.3%
Unrealized loss on investment	3.2	(37.3%)	5.1	-	-	-
Total other expenses and losses	52.2	5.7%	49.3	(3.1%)	50.9	37.6%
Total expenses and losses	$2,028.2	2.8%	$1,973.1	3.1%	$1,913.7	0.2%

Future Economic Factors

The **Commonwealth** ended fiscal year 2013/14 with General Fund collections that were $508.8 million, or 1.7%, less than estimated. The Commonwealth budget, which is highly dependent on a growing economy, faces additional challenges, such as increased pension obligations, wage and benefit increases, debt service, and medical and entitlement costs. These mandated cost drivers are expected to consume virtually all revenue growth. In his *2014/15 Budget in Brief*, Governor Tom Corbett stated that, "While economic forecasts for Pennsylvania are positive, the commonwealth's tax revenue growth is expected to be modest and less than the increase of its major budget cost drivers."

Revenue and Enrollment

In fiscal year 2014/15, the State System will receive $412.8 million in **General Fund appropriations**, the same as received in fiscal years 2013/14, 2012/13, and 2011/12. This funding level is approximately the same as the appropriations the State System received from the Commonwealth in fiscal year 1997/98.

The Commonwealth has continued its commitment to fund the State System's deferred maintenance projects with a Realty Transfer Tax allocation from the **Key '93** funds. The State System has received $13.4 million from this revenue stream in fiscal year 2014/15, a 1.3% decrease from the $13.6 million received in fiscal year 2013/14. Key '93 funds are derived from the Realty Transfer Tax; the actual amount received is an estimate and may be adjusted based upon the health of the real estate market.

The Board approved a $198 (3.0%) **increase in tuition** for the 2014/15 academic year. This sets the new rate for full-time, resident, undergraduate students at $6,820, the lowest among all four-year colleges and universities in Pennsylvania.

With an undergraduate population comprising almost 90% Pennsylvania residents—and the majority of those being traditional-age students enrolling right out of high school—the State System's enrollment historically has been closely tied to the state's high school demographic trends. The National Center for Education Statistics estimates that there were about 3,600 fewer **high school graduates** in Pennsylvania in spring 2013 than in spring 2012, a drop of about 2.7%. This continuing downward trend, which is especially pronounced in western Pennsylvania, is expected to continue for the next three years before leveling off.

Pension Costs

In his *2014/15 Budget in Brief*, Governor Tom Corbett stated:

> *Rising pension costs will claim a significantly larger share of new revenues, threatening to overwhelm the budget and the vital programs and services that it funds. If pensions alone were the only area of state government growing, the challenge posed here might be less acute. But, pensions are not the only area of state government seeing substantial cost growth. As pension costs grow significantly for the next several years without pension reform, the future is likely to include program and service reductions as more and more pressure is put on the commonwealth's budget.*

In fiscal year 2014/15, SERS (State Employees' Retirement System) continued its steep increases in employer **pension contribution rates** that are anticipated to persist through fiscal year 2015/16 and remain high for the foreseeable future. The most predominant employer-paid SERS rates for State System employees rose nearly 32% in 2014/15, after increases of 44% in 2013/14 and more than 50% in 2012/13; the rates are anticipated to increase almost 25% in 2015/16. A similar pattern is occurring with PSERS (Public School Employees' Retirement System). The contribution rate for the ARP (Alternative Retirement Plan), a defined contribution plan, remains unchanged.

In June 2012, GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions*. Statement 68 will require the State System to report on its balance sheet a net **pension liability for SERS and PSERS**, which is the difference between the State System's share of the total SERS and PSERS pension liabilities and the funding set aside in a qualified trust to pay the benefits to current employees, retirees, and their beneficiaries. Although an estimate of the State System's liability has not been calculated by SERS or PSERS, the effect on the financial statements is expected to be significant. The State System will begin recording this liability in fiscal year 2014/15.

SERS

- At December 31, 2013, SERS' actuarial accrued pension liability of $43.9 billion was 59.2% funded, compared to 58.8% funded at December 31, 2012, and 65.3% funded in the previous year.
- The actuarial value of SERS' assets was $25.9 billion at December 31, 2013, compared

to $25.3 billion at December 31, 2012, and $27.6 billion the previous year.
- $17.9 billion of the SERS' actuarial pension liability was unfunded at December 31, 2013, compared to $17.8 billion unfunded at December 31, 2012, and $14.7 billion the previous year. This is debt already incurred by the Commonwealth, and it is an obligation that cannot be eliminated by reducing future benefits. SERS predicts that it may take as many as 40 years to fully fund this liability.
- Employer contributions to SERS in 2013 were only 60.2% of the actuarially calculated Annual Required Contribution, up from 53.9% and 42.8% in 2012 and 2011, respectively.
- The number of new retirees added to the SERS' rolls in 2013 (6,944) was 76% higher than those removed from the rolls (3,953). The annual allowance paid to retirees was 5.4% ($2.5 billion) higher than 2013.
- On a positive note, in 2013 the SERS fund produced investment returns of 13.6%.
- At December 31, 2013, State System employees represented 4.9% of active SERS members.

PSERS
- At June 30, 2013, PSERS' actuarial accrued pension liability of $87.8 billion was 66.3% funded, down from 69.1% funded at June 30, 2012, and 75.1% funded in the previous year.
- The actuarial value of PSERS' assets was $58.2 billion at June 30, 2013, compared to $59.1 billion at June 30, 2012, and $59.3 billion the previous year.
- $29.5 billion of the PSERS' actuarial pension liability was unfunded at June 30, 2013, compared to $26.5 billion unfunded at June 30, 2012, and $19.7 billion unfunded the previous year. This is debt already incurred and cannot be eliminated by reducing future benefits.
- The 2013 employer contributions were only 46% of the actuarially calculated Annual Required Contribution.
- State System employees represent approximately 0.4% of reported member salaries covered under PSERS.

Compensation Costs
Compensation requirements for approximately 87% of State System employees are established in eight separate collective bargaining agreements. The compensation components of all existing agreements end by June 30, 2015, for which successor agreements are currently under negotiation; therefore, salary and wage requirements beyond fiscal year 2014/15 are unknown at this time.

Strategic Plan
In January 2014, the Board approved a new strategic plan with the intention of enhancing and expanding student learning opportunities and ensuring that the Commonwealth receives the greatest possible return on its annual investment in the State System and its 14 universities.

The new long-range plan establishes a series of measurable goals for the State System as a whole, including increasing the number of degrees and certificates awarded annually by the universities; increasing the number of working adult and transfer students enrolled in the System; and boosting graduation rates among all groups of students, especially low-income and underrepresented minority students. The goals are expected to be met by 2020.

Titled ***2020: Rising to the Challenge***, the plan was under development for nearly two years and replaces the State System's previous long-range plan, which was adopted nearly a decade ago. Recognizing the shifting higher education landscape, both in Pennsylvania and nationwide, the plan notes that in order to achieve long-term success, the State System will need to:

- Adapt to an ever-changing student population.
- Align academic programs with real workforce and personal growth needs.
- Provide greater flexibility in how, when, and where students learn.
- Ensure that competition and cooperation within the State System is strategic.
- Preserve and promote accessibility and affordability.
- Enhance accountability and transparency.

The plan calls for increasing from 5,600 to 7,500 the number of degrees or certificates awarded annually in science, technology, engineering and mathematics (STEM) and health-related disciplines. It also calls for increasing the total number of degrees and certificates awarded annually to 31,500.

Under the plan, the State System will aim to increase the number of undergraduate students over the age of 25 to at least 11,000 and the number of community college transfer students to at least 4,000. It also aims to increase to 53,000 the number of students enrolled in classes offered via distance education, including online. About 9,000 nontraditional students—those over age 25—and 3,300 community college transfers are currently enrolled.

In conjunction with the strategic plan, the State System is **realigning programs and resources** to ensure relevance in programs, reduce costs through collaboration, and focus resources on what students want and what the Commonwealth needs.

- More students now are enrolling in new and existing programs in **science, technology, mathematics, business and finance, and allied health** than are enrolling in education and other public service programs, which were the State System's historic strengths.

- The State System continues to **align academic offerings** with workforce needs and student expectations to ensure an institution's degree offerings are relevant and up-to-date. In fiscal year 2013/14, 39 academic programs were placed in moratorium, 30 were reorganized, and 24 new programs were created—all to meet the evolving interests of students and the changing needs of the Commonwealth.

- Universities are realigning faculty and staff resources, as evidenced through **workforce reductions** via attrition and layoffs and the reassignment of vacancies to higher priority positions. Through a combination of retirements, voluntary separations, and furloughs, the State System had 540 (5%) fewer permanent employees in fall 2013 than in fall 2008, while serving approximately the same number of students.

Performance Funding

Calls for increased accountability among colleges and universities have come from various sources across the nation. The State System has more than a decade of experience in this area, having introduced performance funding in 2000/01 and having grown it into a national model. The State System continues to be one of the few public university systems in the nation to voluntarily implement this type of performance program.

State System universities have "earned" nearly **$380 million** through performance since this program's inception. This initiative has resulted in increased graduation and retention rates, especially among underrepresented student groups; greater diversity among both the student population and all employee groups—executives, faculty, and professional staff; and higher fundraising results for the universities despite a still sluggish economy.

The State System is committed to funding its performance program at a level equal to 2.4% of the Educational and General (E&G) budget. The Board allocated **$37.39 million** in performance funding for fiscal year 2014/15, an increase of $0.4 million over fiscal year 2013/14.

Pricing Flexibility Pilot Program

The State System's founding legislation and Board policies provide the framework in which the Board annually sets tuition and university councils of trustees set university fees. In 2014, the Board established a **Pricing Flexibility Pilot Program** to allow State System universities to develop more market-driven pricing practices and assume the financial and operational risks of doing so. This requires Board approval of particular exceptions to existing policy. To date, approval has been granted for a total of 18 pricing pilots at nine universities to be implemented over the next two years. Pricing pilots include differential pricing for high cost/high demand programs or courses, eliminiation of block tuition for 12–18 credits, reduced tuition for military, reduced tuition for off-campus sites, and variable out-of-state student pricing. This new practice is part of the Board's efforts to strike a better balance between State System coordination and more local decision making.

Allocation Formula

Effective fiscal year 2014/15 the Board of Governors approved a **new allocation formula** for the distribution of state appropriations to the universities. The new formula consists of a fixed-cost component for all universities and variable components for instruction, support services, and physical plant. These variable components are similar to the previous formula. Although still primarily enrollment driven, the new formula is designed to provide greater stability and predictability. Migration to the new formula will occur over three years.

Cheyney University

Cheyney University ended fiscal year 2013/14 with a $4.2 million loss in Unrestricted funds and an Unrestricted Net Position deficit of $6.7 million (excluding unfunded postretirement and compensated absences liabilities). Net tuition and fees dropped $1.8 million. In some months cash flow at the University has been negative, requiring the University to borrow $4.75 million from the State

System to meet payroll and other operating obligations; it is anticipated that the University will need to borrow another $2 million for operations by December 31, 2014. The University projects an Unrestricted budget deficit of $8 million for FY 2014/15.

A significant cause of this deterioration is the persistent failure of the University's financial aid office to timely and accurately process federal and state student financial aid, which are the primary sources of tuition revenue. In spring 2014, the State System sent a management team from the Office of the Chancellor to the University to restructure the financial aid division and implement new processes, and a financial aid consultant has been engaged to correct all previously processed awards. It is reasonably possible that when the consultant's work is completed, which is anticipated by November 2014, the University will be required to record a liability to the Federal Department of Education for improperly awarded student financial aid. An estimate of this potential liability cannot yet be calculated.

Another significant cause for the deterioration is the failure of management to match its academic course offerings to student demand, retrench and reorganize faculty to effectively deliver the necessary and desired courses, and mothball unoccupied facilities as enrollment has dropped from 1,740 students in 2007 to an estimated 1,020 students in fall 2014, a 41% decrease. Without these structural changes, the University cannot achieve additional cost savings.

The State System, through the Office of the Chancellor, is partnering with Cheyney governance and management to stabilize its financial condition and implement a comprehensive plan for operational effectiveness that includes timely and accurate financial aid processing, increasing student enrollment, restructuring course offerings, and right-sizing personnel and facilities.

Moody's Rating and Outlook

In April 2014, Moody's Investors Service, Inc. (Moody's), reaffirmed the State System's **bond rating** of Aa3, but revised the outlook from *stable* to *negative*. In its April 7, 2014, Summary Rating Rationale, Moody's stated:

> *The Aa3 reflects PASSHE's large scale as a system of 14 campuses located throughout the state of Pennsylvania (Aa2, stable) operating in a highly competitive environment, strong unrestricted liquidity and still good cash flow to cover debt service. These strengths are offset by high leverage (including privatized student housing), constrained revenues, and a rigid expense structure due to the largely unionized faculty and staff. The negative outlook reflects earlier and larger than expected declines in enrollment leading to more pressured operations. Cash flow is expected to thin as revenues stagnate and retirement benefit costs and other expenses rise. Should enrollment declines continue to be larger than anticipated and performance deteriorate further despite management's various initiatives to address the system's challenges, the rating could be downgraded.*

Moody's details as State System "**challenges**" the declining number of Commonwealth high school graduates, unionized faculty and staff, rising pension and health care benefit costs, $2.26 billion of total debt (including privatized student housing debt issued for replacement of student residences), and three years of flat operating support from the Commonwealth with no proposed increase for the future.

Moody's details as State System **strengths** its position as one of the nation's largest systems, its consistently favorable operating cash flow at 2.4 times annual debt service coverage, current and expected substantial unrestricted liquidity, and modest near-term debt plans with rapidly amortizing outstanding debt that should improve its leverage profile.

Moody's predicts that an upgrade in the near-term is unlikely given the *negative* outlook, but that a return to a *stable* outlook could be driven by consistently stronger operating performance and cash flow generation, stabilized student demand, and growing net tuition per student. Conversely, a rating downgrade could result from stagnant or declining tuition, weaker operating cash flow from failure to retrench operations, deterioration of balance sheet liquidity, or further material increases in debt.

For ***further information*** *about these financial statements, contact Pennsylvania's State System of Higher Education, Accounting Office, 2986 North Second Street, Harrisburg, PA 17110.*

Pennsylvania's State System of Higher Education

Balance Sheet

(dollars in thousands)

Assets and Deferred Outflows of Resources

	June 30, 2014	*Restated* June 30, 2013
Current Assets		
Cash and cash equivalents	$ 48,528	$ 35,887
Short-term investments	490,897	406,478
Accounts receivable, students, net of allowance for doubtful accounts of $29,963 in 2014 and $28,121 in 2013	42,776	45,915
Accounts receivable, other	19,608	12,820
Governmental grants and contracts receivable	25,806	27,263
Inventories	3,471	3,624
Prepaid expenses	10,394	8,400
Current portion of loans receivable, net	8,714	6,360
Due from component units	20,214	19,345
Other current assets	1,705	2,087
Total Current Assets	672,113	568,179
Noncurrent Assets		
Restricted cash and cash equivalents	25	25
Endowment investments	29,622	25,702
Other long-term investments	794,056	894,724
Loans receivable, net of allowance for doubtful accounts of $0 in 2014 and $5,791 in 2013	32,748	27,466
Due from component units	11,491	14,099
Capital Assets:		
Land	32,360	29,263
Buildings, including improvements	2,039,800	1,953,267
Improvements other than buildings	264,498	242,462
Equipment and furnishings	454,757	445,431
Library books	83,690	83,911
Construction in progress	70,206	103,782
	2,945,311	2,858,116
Less accumulated depreciation	(1,328,503)	(1,228,541)
Capital assets, net	1,616,808	1,629,575
Other noncurrent assets	1,362	1,424
Total Noncurrent Assets	2,486,112	2,593,015
Total Assets	3,158,225	3,161,194
Deferred Outflows of Resources		
Unamortized loss on refunding of debt	6,527	7,085
Total Assets and Deferred Outflows of Resources	$ 3,164,752	$ 3,168,279

See accompanying notes to financial statements.

Pennsylvania's State System of Higher Education

Balance Sheet
(dollars in thousands)

Liabilities, Deferred Inflows of Resources, and Net Position

	June 30, 2014	*Restated* June 30, 2013
Current Liabilities		
Accounts payable and accrued expenses	$ 147,001	$ 145,133
Unearned revenue	50,990	53,140
Deposits	41,910	34,652
Current portion of workers' compensation liability	4,776	4,803
Current portion of compensated absences liability	11,355	11,585
Current portion of postretirement benefits liability	59,295	56,154
Current portion of capitalized lease obligations	3,226	3,345
Current portion of bonds payable	54,695	46,970
Due to component units	10,474	9,515
Other current liabilities	34,733	29,770
Total Current Liabilities	418,455	395,067
Noncurrent Liabilities		
Unearned revenue	4,916	3,383
Deposits	283	388
Workers' compensation liability	16,934	16,541
Compensated absences liability	103,355	98,324
Postretirement benefits liability	947,776	877,536
Capitalized lease obligations	50,565	53,537
Bonds payable	805,195	852,835
Other noncurrent liabilities	77,893	78,778
Total Noncurrent Liabilities	2,006,917	1,981,322
Total Liabilities	2,425,372	2,376,389
Deferred Inflows of Resources		
Unamortized gain on refunding of debt	332	91
Net Position		
Net investment in capital assets	684,396	647,700
Restricted for:		
Nonexpendable:		
Scholarships and fellowships	10,662	9,868
Other	8,273	1,271
Expendable:		
Scholarships and fellowships	36,049	32,114
Research	1,574	644
Student loans	551	1,513
Capital projects	38,369	39,653
Other	7,835	7,420
Unrestricted	(48,661)	51,616
Total Net Position	739,048	791,799
Total Liabilities, Deferred Inflows of Resources, and Net Position	$ 3,164,752	$ 3,168,279

See accompanying notes to financial statements.

Pennsylvania's State System of Higher Education

Statement of Revenues, Expenses, and Changes in Net Position
For the Years Ended June 30, 2014 and 2013
(dollars in thousands)

	2014		Restated 2013	
Operating Revenues				
Tuition and fees	$ 1,029,150		$ 1,015,386	
Less scholarship discounts and allowances	(219,840)		(211,187)	
Net tuition and fees		$ 809,310		$ 804,199
Governmental grants and contracts:				
Federal		38,268		42,161
State		109,812		104,167
Local		3,901		3,800
Nongovernmental grants and contracts		8,849		7,790
Sales and services		39,003		34,749
Auxiliary enterprises, net of discounts of $928 in 2014 and $890 in 2013		331,431		332,890
Other revenues		14,089		9,777
Total Operating Revenues		1,354,663		1,339,533
Operating Expenses				
Instruction		720,970		704,473
Research		5,115		5,419
Public service		37,457		34,233
Academic support		171,911		170,773
Student services		176,618		170,270
Institutional support		263,981		258,068
Operations and maintenance of plant		152,304		143,214
Depreciation		120,193		119,536
Student aid		75,592		74,488
Auxiliary enterprises		251,781		243,320
Total Operating Expenses		1,975,922		1,923,794
Operating Loss		(621,259)		(584,261)
Nonoperating Revenues (Expenses)				
State appropriations, general and restricted		412,751		412,751
Pell grants		143,572		140,585
Investment income, net of related investment expense of $465 in 2014 and $432 in 2013		26,226		20,409
Unrealized loss on investments		(3,179)		(5,131)
Gifts for other than capital purposes		17,791		15,124
Interest expense on capital asset-related debt		(36,862)		(37,936)
Loss on disposal of assets		(12,055)		(6,347)
Other nonoperating revenue		1,504		1,334
Net Nonoperating Revenues		549,748		540,789
Loss before other revenues		(71,511)		(43,472)
State appropriations, capital		14,385		14,835
Capital gifts and grants		4,375		14,708
Decrease in Net Position		(52,751)		(13,929)
Net position—beginning of year		791,799		812,727
Restatement for bond issuance costs as required by GASB 65		-		(6,999)
Net position—beginning of year, restated				805,728
Net position—end of year		$ 739,048		$ 791,799

See accompanying notes to financial statements.

Pennsylvania’s State System of Higher Education

Statement of Cash Flows
For the Years Ended June 30, 2014 and 2013

(dollars in thousands)

	2014	2013
Cash Flows from Operating Activities		
Tuition and fees	$ 808,988	$ 804,269
Grants and contracts	161,103	184,169
Payments to suppliers for goods and services	(446,878)	(440,752)
Payments to employees	(1,256,943)	(1,219,854)
Loans issued to students	(8,532)	(5,474)
Loans collected from students	5,346	6,069
Student aid	(76,363)	(75,070)
Auxiliary enterprise charges	333,019	333,303
Sales and services	38,729	36,138
Other receipts (payments)	14,650	(15,329)
Net cash used in operating activities	(426,881)	(392,531)
Cash Flows from Noncapital Financing Activities		
State appropriations	412,751	412,751
Gifts and nonoperating grants for other than capital purposes	161,086	155,542
PLUS, Stafford, and other loans receipts (non-Perkins)	735,150	792,193
PLUS, Stafford, and other loans disbursements (non-Perkins)	(735,202)	(792,245)
Agency transactions, net	7,918	15,053
Other	1,504	1,334
Net cash provided by noncapital financing activities	583,207	584,628
Cash Flows from Capital Financing Activities		
Proceeds from capital debt and leases	105,656	-
Capital appropriations	14,233	13,897
Capital grants and gifts received	3,166	11,154
Proceeds from sales of capital assets	354	80
Purchases of capital assets	(115,470)	(114,235)
Principal paid on capital debt and leases	(141,732)	(50,952)
Interest paid on capital debt and leases	(44,387)	(45,156)
Net cash used in capital financing activities	(178,180)	(185,212)
Cash Flows from Investing Activities		
Proceeds from sales and maturities of investments	17,987,001	22,100,511
Interest on investments	26,090	20,718
Purchase of investments	(17,978,593)	(22,115,940)
Net cash provided by investing activities	34,498	5,289
Net Increase in Cash and Cash Equivalents	12,641	12,174
Cash and cash equivalents—beginning of year	35,912	23,738
Cash and cash equivalents—end of year	$ 48,553	$ 35,912

See accompanying notes to financial statements.

Pennsylvania’s State System of Higher Education

Statement of Cash Flows
For the Years Ended June 30, 2014 and 2013
(dollars in thousands)

	2014	2013
Reconciliation of Operating Loss to Net Cash Used in Operating Activities		
Operating loss	$ (621,259)	$ (584,261)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation expense	120,193	119,536
Expenses paid by Commonwealth or donor	295	251
Changes in assets and liabilities:		
Receivables, net	3,354	33,123
Inventories	153	239
Other assets	(6,639)	(11,937)
Accounts payable	(2,803)	(10,302)
Unearned revenue	(522)	(1,751)
Student deposits	(125)	(2,259)
Compensated absences	4,802	1,703
Loans to students and employees	(3,187)	595
Other liabilities	78,857	62,532
Net cash used in operating activities	$ (426,881)	$ (392,531)
Noncash Capital Financing Activities		
Capital assets included in payables	$ 2,818	$ 3,169
Capital assets acquired through capital leases	$ 304	$ 10,345
Like-kind exchanges	$ 106	$ 1,451
Capital assets acquired by gift or appropriation	$ 1,244	$ 3,611

See accompanying notes to financial statements.

Pennsylvania's State System of Higher Education

Component Units Statement of Financial Position

(dollars in thousands)

	June 30, 2014	*Restated* June 30, 2013
Assets		
Cash and cash equivalents	$ 137,306	$ 136,188
Accounts receivable	6,049	5,818
Contributions/pledges receivable	16,844	15,938
Due from universities	11,158	10,359
Inventories	7,078	8,030
Short-term investments	26,457	32,606
Investments	547,443	528,215
Capital assets:		
Land	31,074	29,770
Buildings	1,120,274	1,044,610
Building improvements	16,974	14,787
Improvements other than buildings	10,306	9,124
Equipment and furnishings	84,905	76,226
Construction in progress	160,792	91,177
	1,424,325	1,265,694
Less accumulated depreciation	(245,846)	(208,474)
Capital assets, net	1,178,479	1,057,220
Other assets	138,502	142,155
Total Assets	$ 2,069,316	$ 1,936,529
Liabilities		
Accounts payable and accrued expenses	$ 40,394	$ 37,780
Annuity liabilities	8,054	8,040
Due to universities	31,230	34,662
Deposits payable	22,127	19,553
Capitalized leases	30,612	31,562
Bonds payable	1,199,328	1,158,761
Notes payable	288,071	246,322
Other liabilities	91,735	102,525
Total Liabilities	1,711,551	1,639,205
Net Assets		
Unrestricted	15,510	(2,270)
Temporarily restricted	93,877	81,401
Permanently restricted	248,378	218,193
Total Net Assets	357,765	297,324
Total Liabilities and Net Assets	$ 2,069,316	$ 1,936,529

See accompanying notes to financial statements.

Pennsylvania's State System of Higher Education

Component Units Statement of Activities
For the Years Ended June 30, 2014 and 2013

(dollars in thousands)

	2014	*Restated* 2013
Revenues and Gains		
Contributions	$ 39,635	$ 34,231
Sales and services	50,724	55,142
Student fees	34,840	33,818
Grants and contracts	10,799	9,845
Rental income	147,319	133,859
Investment income	14,150	11,390
Unrealized gains related to investment activity	35,059	54,174
Other revenues and gains	20,866	9,145
Total Revenues and Gains	353,392	341,604
Expenses and Losses		
Program services:		
Scholarships and grants	12,573	11,576
Student activities and programs	31,766	30,991
University stores	30,967	37,124
Housing	142,717	131,254
Other university support	16,372	23,146
Other programs	18,200	13,952
Management and general	29,087	29,359
Fundraising	8,465	8,395
Unrealized losses related to investment activity	2,804	323
Total Expenses and Losses	292,951	286,120
Change in Net Assets	60,441	55,484
Net assets—beginning of year	297,324	236,069
Restatement to add new component units		5,771
Net assets—beginning of year, restated		241,840
Net assets—end of year	$ 357,765	$ 297,324

See accompanying notes to financial statements.

NOTES TO FINANCIAL STATEMENTS
Years Ended June 30, 2014 and 2013

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The Pennsylvania's State System of Higher Education (State System) is a body corporate and politic, created by the State System of Higher Education Act of November 12, 1982, P.L. 660, No. 188, as amended (Act 188). The State System is a component unit of the Commonwealth of Pennsylvania (Commonwealth) and is governed by a Board of Governors (Board), as provided for in Act 188. The State System comprises the 14 universities and the Office of the Chancellor.

Reporting Entity

The State System functions as a Business Type Activity, as defined by the Governmental Accounting Standards Board (GASB).

Certain affiliated organizations are included in the State System's financial statements as discretely presented component units. Some of the organizations, such as university student associations, are included because the Board has oversight responsibility for the organizations. The criteria used in determining the organizations for which the State System has oversight responsibility include financial interdependency, the ability to select members of the governing body, the ability to designate management, the ability to influence operations significantly, and accountability for fiscal matters. Other affiliated organizations for which the Board does not have oversight responsibility, such as university foundations and alumni associations, are included when the economic resources received or held by the organization are entirely or almost entirely for the direct benefit of the State System, the activity of the organization is significant to the State System universities, and the State System historically has received a majority of these economic resources. Neither the State System nor its universities control the timing or amount of receipts from these organizations. In fiscal year 2013/14, the State System determined that an additional three of its affiliates met the criteria of being discretely presented component units and they are included in the accompanying component unit financial statements.

The State System does not consider any of its component units to be major, and has aggregated all component unit information into a separate set of financial statements. Information on individual component units can be obtained by contacting the respective universities.

Transactions between the universities and the Office of the Chancellor have been eliminated in the accompanying financial statements.

Measurement Focus, Basis of Accounting, and Basis of Presentation

The accompanying financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America, as prescribed by GASB. The economic resources measurement focus reports all inflows, outflows, and balances that affect an entity's net assets. Under the accrual basis of accounting, revenues are recorded when earned, and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements have been met.

The accompanying financial statements of the component units, which are all private nonprofit organizations, are reported in accordance with Financial Accounting Standards Board (FASB) requirements, including FASB Statement No. 117, *Financial Reporting for Not-for-Profit Organizations*. As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition criteria and presentation features. No modifications for these differences have been made to the component units' financial information presented herein.

Operating Revenues and Expenses

The State System records tuition; all academic, instructional, and other student fees; student financial aid; auxiliary activity; corporate partnerships; and revenue from cogeneration sales as operating revenue. In addition, governmental and private grants and contracts in which the grantor receives equal value for the funds given to the university are recorded as operating revenue. All expenses, with the exception of interest expense, loss on investments, loss on the disposal of assets, and extraordinary expenses, are recorded as operating expenses. Appropriations, gifts, investment income, capital grants, gains on investments, gains on the disposal of assets, parking and library fines, and governmental and private research grants and contracts in which the grantor does not receive equal value for the funds given to the university are reported as nonoperating revenue.

Net Position *(previously Net Assets)*

Net position is the residual of Assets, plus Deferred Outflows of Resources, less Liabilities, less Deferred Inflows of Resources. The State System maintains the following classifications of net position.

Net investment in capital assets: Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction, repair, or improvement of those assets.

Restricted—nonexpendable: The portion of net position subject to externally imposed conditions requiring that it be maintained by the State System in perpetuity.

Restricted—expendable: The portion of net position use of which is subject to externally imposed conditions that can be fulfilled by the actions of the State System or by the passage of time.

Unrestricted: All other categories of net position. Unrestricted net position may be designated for specific purposes by the Board.

When both restricted and unrestricted funds are available for expenditure, the decision as to which funds are used first is left to the discretion of the universities.

Cash Equivalents and Investments

The State System considers all demand and time deposits and money market funds to be cash equivalents. Investments purchased are stated at fair value. Investments received as gifts are recorded at their fair value or appraised value as of the date of the gift. The State System classifies investments as short-term when they are readily marketable and intended to be converted to cash within one year.

Accounts and Loans Receivable

Accounts and loans receivable consist of tuition and fees charged to current and former students and amounts due from federal and state governments in connection with reimbursements of allowable expenditures made pursuant to grants, contracts, and other miscellaneous sources.

Accounts and loans receivable are reported at net realizable value. Accounts are written off when they are determined to be uncollectible based upon management's assessment of individual accounts. The allowance for doubtful accounts is estimated based upon the universities' historical losses and periodic review of individual accounts.

Inventories

Inventories are stated at the lower of cost or market, with cost being determined principally on the weighted average method.

Capital Assets

Land and buildings at the 14 university campuses acquired or constructed prior to its creation on July 1, 1983, are owned by the Commonwealth and made available to the universities of the State System. Since the State System neither owns such assets nor is responsible to service associated bond indebtedness, no value is ascribed thereto in the accompanying financial statements. Likewise, no value is ascribed to the portion of any land or buildings acquired or constructed using capital funds appropriated by the Commonwealth after

June 30, 1983, and made available to the universities.

All assets with a purchase cost, or fair value if acquired by gift, in excess of $5,000, with an estimated useful life of two years or greater, are capitalized. Buildings, portions of buildings, and capital improvements acquired or constructed by the universities after June 30, 1983, through the expenditure of university funds or the incurring of debt are stated at cost less accumulated depreciation.

Equipment and furnishings are stated at cost less accumulated depreciation. Library books are capitalized and depreciated. Assets under capital leases are recorded at the lower of the present value of the minimum lease payments or the fair value of the asset. The State System provides for depreciation on the straight-line method over the estimated useful lives of the related assets. Buildings and improvements are depreciated over useful lives ranging from 10 to 40 years. Equipment and furnishings are depreciated over useful lives ranging from 3 to 10 years. Library books are depreciated over 10 years. Amortization of assets under capital leases is included in depreciation expense. Normal repair and maintenance expenditures are not capitalized because they neither add to the value of the property nor materially prolong its useful life.

The State System does not capitalize collections of art, rare books, historical items, etc., as they are held for public exhibition, education, or research rather than financial gain.

Impairment of Capital Assets

Management reviews capital assets for impairment whenever events or changes in circumstances indicate that the service utility of an asset has declined significantly and unexpectedly. Any write-downs due to impairment are charged to operations at the time impairment is identified. No write-down of capital assets was required for the years ended June 30, 2014 and 2013.

Unearned Revenue *(previously Deferred Revenue)*

Unearned revenue includes amounts for tuition and fees, grants, corporate sponsorship payments, and certain auxiliary activities received prior to the end of the fiscal year but earned in a subsequent accounting period. The State System previously referred to "unearned revenue" as "deferred revenue," but changed the terminology in accordance with new GASB requirements.

Compensated Absences

Employees' right to receive annual leave and sick leave payments upon termination or retirement for services already rendered is recorded as a liability.

Pension Plans

Employees of the State System enroll in one of three available retirement plans immediately upon employment. The State System recognizes annual pension expenditures equal to its contractually required contributions to the plan.

Deferred Outflows and Deferred Inflows of Resources

The balance sheet reports separate sections for *Deferred Outflows of Resources* and *Deferred Inflows of Resources*.

Deferred Outflows of Resources, reported after *Total Assets,* is defined by GASB as a consumption of net position that applies to future periods. The expense is recognized in the applicable future period(s). The State System has one item that is required to be reported in this category: the deferred loss on bond defeasance, which results when the carrying value of a defeased bond is less than its reacquisition price. The difference is deferred and amortized over the remaining life of the old bond or the life of the new bond, whichever is shorter.

Deferred Inflows of Resources, reported after *Total Liabilities,* is defined by GASB as an acquisition of net position that applies to future periods. The revenue is recognized in the applicable future period(s). The State System has one item that is required to be reported in this category: the deferred gain on bond defeasance, which results when the carrying value of a defeased bond is greater than its reacquisition price. The difference is deferred and amortized over the remaining life of the old bond or the life of the new bond, whichever is shorter.

Transactions are classified as deferred outflows of resources or deferred inflows of resources only when specifically prescribed by GASB standards.

Scholarships and Waivers

In accordance with a formula prescribed by the National Association of College and University

Business Officers (NACUBO), the State System allocates the cost of scholarships, waivers, and other student financial aid between *Scholarship discounts and allowances* (netted against tuition and fees) and *Student aid expense*. Scholarships and waivers of room and board fees are reported in Auxiliary enterprises. The cost of tuition waivers granted to employees is reported as employees' benefits expense.

Income Taxes

The State System and its member universities are tax-exempt; accordingly, no provision for income taxes has been made in the accompanying financial statements.

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 of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain amounts in the prior period presented have been reclassified to conform to the current period financial statement presentation. These reclassifications have no effect on previously reported change in net position.

New Accounting Standards

The State System has implemented GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. Statement No. 65 establishes accounting and financial reporting standards that (a) reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that previously were reported as assets and liabilities; and (b) recognize, as revenues or expenses, certain items that previously were reported as assets and liabilities. As a result, bond issuance costs, which previously were netted against the associated bond discount or bond premium on the balance sheet and amortized over the life of the associated bond payable, now are expensed in the period incurred. The fiscal year 2012/13 bond issuance costs expense of $850,000 is included in the Statement of Revenues, Expenses, and Changes in Net Position as a restatement to the *2013 Decrease in Net Position*. The June 30, 2012, balance of the deferred bond issuances costs of $6,999,000 is included in the Statement of Revenues, Expenses, and Changes to Net Position as a restatement to the *2013 Net position—beginning of year*.

(in thousands)

	2013
Decrease in Net Position, as previously stated	$(14,779)
FY 2012/13 bond issuance costs	850
Decrease in Net Position, restated	$(13,929)

	2013
Net position—beginning of year, as previously stated	$812,727
Unamortized balance of June 30, 2012, bond issuance costs	(6,999)
Net position—beginning of year, restated	$805,728

Amounts representing the unamortized gain or loss on bond defeasance, which previously were netted and classified as other liabilities, are now reported as deferred outflows of resources (unamortized loss) or deferred inflows of resources (unamortized gain).

In June 2012, GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions*. In November 2013, GASB issued Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*. Statements No. 68 and 71 will require the State System to report its share of the pension liabilities that the Commonwealth of Pennsylvania State Employees' Retirement System (SERS) and Public School Employees' Retirement System (PSERS) must record beginning in fiscal year 2014/15. Although the State System has not received an estimate of its share of the pension liabilities from either organization, the liabilities are expected to be significant and have a detrimental effect on its financial statements.

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations*. Statement No. 69 establishes accounting and financial reporting standards related to government combinations and disposals of government operations. In April 2013, GASB issued Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*. Statement No. 70 specifies the information required to be disclosed by governments that extend nonexchange financial guarantees. The State System has determined that Statements No. 69 and 70 have no effect on its financial statements.

(2) Deposits and Investments

Board Policy 1986-02-A, *Investment*, authorizes the State System to invest in obligations of the U.S. Treasury, repurchase agreements, commercial paper, certificates of deposit, banker's acceptances, U.S. money market funds, municipal bonds, corporate bonds, collateralized mortgage obligations (CMOs), asset-backed securities, and internal loan funds. Restricted nonexpendable funds and amounts designated by the Board or university trustees may be invested in the investments described above as well as in corporate equities and approved pooled common funds. For purposes of convenience and expedience, universities use local financial institutions for activities such as deposits of cash. In addition, universities may accept gifts of investments from donors as long as risk is limited to the investment itself. Restricted gifts of investments fall outside the scope of the investment policy.

In keeping with its legal status as a system of public universities, the State System recognizes a fiduciary responsibility to invest all funds prudently and in accordance with ethical and prevailing legal standards. Investment decisions are intended to minimize risk while maximizing asset value. Adequate liquidity is maintained so that assets can be held to maturity. High quality investments are preferred. Reasonable portfolio diversification is pursued to ensure that no single security or investment or class of securities or investments will have a disproportionate or significant impact on the total portfolio. Investments may be made in U.S. dollar-denominated debt of high quality U.S. and non-U.S. corporations. Investment performance is monitored on a frequent and regular basis to ensure that objectives are attained and guidelines are followed.

Safety of principal and liquidity are the top priorities for the investment of the State System's operating funds. Within those guidelines, income optimization is pursued. Speculative investment activity is not allowed; this includes investing in asset classes such as commodities, futures, short-sales, equities, real or personal property, options, venture capital investments, private placements, letter stocks, and unlisted securities.

The State System's operating funds are invested and reinvested in the following types of instruments with qualifications as provided. (See Board Policy 1986-02-A, *Investment*, for a complete list of and more details on permissible investments and associated qualifications.)

Investment Categories	Qualifications/Moody's Ratings Requirements
United States Government Securities	Together with repurchase agreements, must comprise at least 20% of the market value of the fund.
Repurchase Agreements	Underlying collateral must be direct obligations of the United States Treasury and be in the State System's or its agent's custody.
Commercial Paper	P-1 and P-2 notes only, with no more than 5% and 3%, respectively, of the market value of the fund invested in any single issuer. Total may not exceed 20% of the market value of the fund.
Municipal Bonds	Bonds must carry long-term debt rating of A or better. Total may not exceed 20% of the market value of the fund.
Corporate Bonds	15% must carry long-term debt rating of A or better; 5% may be rated Baa2 or better. Total may not exceed 20% of the market value of the fund.
Collateralized Mortgage Obligations (CMOs)	Must be rated Aaa and guaranteed by the U.S. government. Total may not exceed 20% of the market value of the fund.
Asset-Backed Securities	Must be Aaa rated. Total may not exceed 20% of the market value of the fund, with no more than 5% invested in any single issuer.
System Investment Fund Loans (university loans and bridge notes)	Total may not exceed 20% of the market value of the fund, and loan terms may not exceed 5 years.

CMO Risk: CMOs sometimes are based on cash flows from interest-only (IO) payments or principal-only (PO) payments and are sensitive to prepayment risks. The CMOs in the State System's portfolio do not have IO or PO structures; however, they are subject to extension or contraction risk based on movements in interest rates.

Moody's Rating: The State System uses ratings from Moody's Investors Service, Inc., to indicate the credit risk of investments, i.e., the risk that an issuer or other counterparty to an investment will not fulfill its obligations. An *Aaa* rating indicates the highest quality obligations with minimal credit risk. Ratings that begin with *Aa* indicate high quality obligations subject to very low credit risk; ratings that begin with *A* indicate upper-medium-grade obligations subject to low credit risk; and ratings that begin with *Baa* indicate medium-grade obligations, subject to moderate credit risk, that may possess certain speculative characteristics. Moody's appends the ratings with numerical modifiers *1*, *2*, and *3*, with *1* indicating a higher ranking and *3* indicating a lower ranking within the category. For short-term obligations, a rating of *P-1* indicates that issuers have a superior ability to repay short-term debt obligations, and a rating of P-2 indicates that issuers have a strong ability to repay short-term debt obligations.

Modified Duration: The State System denotes interest rate risk, or the risk that changes in interest rates will affect the fair value of an investment, using *modified duration*. *Duration* is a measurement in years of how long it takes for the price of a bond to be repaid by its internal cash flows. *Modified duration* takes into account changing interest rates. The State System maintains a portfolio duration target of 1.8 years with an upper limit of 2.5 years for the intermediate-term component of the operating portion of the investment portfolio. The State System's duration targets are not applicable to its long-term investments.

On June 30, 2014 and 2013, the carrying amount of the State System's demand and time deposits and certificates of deposit for all funds was $48,576,000 and $35,935,000, respectively, compared to bank balances of $48,688,000 and $36,437,000, respectively. The difference is caused primarily by items in transit. Of the bank balances, $3,334,000 and $6,065,000, respectively, were covered by federal government depository insurance or collateralized by a pledge of U.S. Treasury obligations held by Federal Reserve banks in the name of the banking institutions; $629,000 and $1,547,000, respectively, were uninsured and uncollateralized; and $44,725,000 and $28,825,000, respectively, were uninsured and uncollateralized but covered under the collateralization provisions of the Commonwealth of Pennsylvania Act 72 of 1971, as amended. Act 72 allows banking institutions to satisfy the collateralization requirements by pooling eligible investments to cover total public funds on deposit in excess of federal insurance. Such pooled collateral is pledged with the financial institutions' trust departments.

The carrying values (fair values) of deposits and investments for the State System's pooled funds in M&T Bank on June 30, 2014 and 2013, follow.

State System Pooled Deposits and Investments
June 30, 2014
(in thousands)

	Moody's Rating (if applicable)	**Modified Duration** (if applicable)	**Fair Value**
Deposits			
Money market funds			$36,981
Total deposits			36,981
Investments			
Repurchase agreements			13,749
Commercial paper	P1	0.11	181,411
U.S. government and agency obligations	Aaa	3.10	410,727
Asset-backed securities	Aaa	1.55	110,487
	A1	0.83	2,928
	P1	0.95	68,762
Collateralized mortgage obligations (CMOs)	Aaa	2.74	214,795
Corporate bonds and notes	Aaa	2.04	11,527
	Aa1	3.77	15,316
	Aa2	1.61	18,437
	Aa3	1.23	25,185
	A1	1.64	23,345
	A2	1.92	59,885
	A3	1.42	57,286
	Baa1	1.46	34,430
	Baa2	1.72	20,661
	Baa3	0.00	725
Total investments			1,269,656
Total deposits and investments			$1,306,637

State System Pooled Deposits and Investments
June 30, 2013
(in thousands)

	Moody's Rating (if applicable)	**Modified Duration** (if applicable)	**Fair Value**
Deposits			
Money market funds			$19,105
Total deposits			19,105
Investments			
Repurchase agreements			14,260
Commercial paper	P1	0.06	138,604
U.S. government and agency obligations	Aaa	2.94	475,390
Asset-backed securities	Aaa	0.96	80,275
	P1	0.22	95,200
Collateralized mortgage obligations (CMOs)	Aaa	2.16	228,091
Corporate bonds and notes	Aaa	1.66	29,042
	Aa1	4.73	4,683
	Aa2	1.80	24,106
	Aa3	1.39	40,800
	A1	1.29	26,236
	A2	2.30	42,073
	A3	2.49	33,373
	Baa1	1.83	25,309
	Baa2	2.36	30,258
	Baa3	0.00	725
Total investments			1,288,425
Total deposits and investments			$1,307,530

Of the investments noted above at June 30, 2014 and 2013, $19,819,000 and $17,071,000, respectively, were held by a trustee to be used for projects funded under the Pennsylvania Higher Educational Facilities Authority/State System of Higher Education bond issues (note 8). Investments are made subject to the restrictions of the bond indenture and may be liquidated only for the payment of costs associated with the projects described in the bond indenture.

The carrying values (fair values) of local university deposits and investments on June 30, 2014 and 2013, follow.

University Local Deposits and Investments
June 30, 2014
(in thousands)

	Moody's Rating (if applicable)	**Modified Duration** (if applicable)	**Fair Value**
Deposits			
Demand and time deposits			$11,572
Certificates of deposit			23
Total deposits			11,595
Investments			
U.S. government and agency obligations		3.43	411
Bond mutual funds		4.68	5,936
Debt securities		5.03	80
Equity/balanced mutual funds			36,013
Common stock			2,456
Total investments			44,896
Total deposits and investments			$56,491

University Local Deposits and Investments
June 30, 2013
(in thousands)

	Moody's Rating (if applicable)	**Modified Duration** (if applicable)	**Fair Value**
Deposits			
Demand and time deposits			$16,807
Certificates of deposit			23
Total deposits			16,830
Investments			
U.S. government and agency obligations		2.00	414
Bond mutual funds		5.45	5,266
Debt securities		4.77	54
Equity/balanced mutual funds			29,798
Common stock			2,924
Total investments			38,456
Total deposits and investments			$55,286

Of the local investments noted above, the exposure to foreign currency risk is as follows.

(*in thousands*)		Fair Value	
Investment	**Currency**	June 30, 2014	June 30, 2013
Deposit	British Pound	$7	$12

The universities are beneficiaries of trust funds held by others with an approximate fair value of $4,091,000 and $3,870,000 on June 30, 2014 and 2013, respectively. Since the universities have neither possession nor control of these trusts, the principal is not included in the accompanying balance sheet.

(3) Leases

Total rent expense for the State System operating leases amounted to $11,676,000 and $8,292,000 for the years ended June 30, 2014 and 2013, respectively.

Capital assets acquired through leases that have been capitalized are as follows:

(*in thousands*)	June 30, 2014	June 30, 2013
Cost:		
Construction in Progress	-	$9,820
Buildings	$76,405	65,599
Equipment	3,625	3,490
Total	$80,030	$78,909
Accumulated Depreciation:		
Buildings	$29,471	$25,216
Equipment	2,269	1,785
Total	$31,740	$27,001

Future minimum payments, by year and in the aggregate, under capital and noncancelable operating leases, with initial or remaining terms of one year or more, are as follows.

(*in thousands*)	**Operating Leases**	**Capital Leases**
2015	$6,252	$5,706
2016	4,948	5,453
2017	3,511	5,325
2018	1,978	5,209
2019	1,307	5,157
Thereafter	60,409	47,880
Total minimum lease payments	$78,405	74,730
Amount representing interest on capital leases		20,939
Present value of net minimum capital lease payments		$53,791

Changes in the liability for capital leases in fiscal years 2014 and 2013 follow.

(*in thousands*) **Year**	**Beginning Balance**	**Capital Lease Additions**	**Capital Lease Payments**	**Ending Balance**
2013	$55,520	$10,345	$8,983	$56,882
2014	$56,882	$304	$3,395	$53,791

(4) Pension Benefits

The Public School Employees' Retirement System (PSERS) and the Commonwealth of Pennsylvania State Employees' Retirement System (SERS) are governmental cost-sharing multiple-employer defined benefit plans. The Alternative Retirement Plan (ARP) is a defined contribution plan administered by the State System.

PSERS provides retirement and disability benefits, legislative mandated ad hoc cost-of-living adjustments, and health care insurance premium assistance to qualifying annuitants. The Public School Employees' Retirement Code (Act No. 96 of October 2, 1975, as amended) (24 Pa. C.S. §§8101–9102) is the authority by which PSERS benefits provisions are established and may be amended. The contribution policy for PSERS is established in the Public School Employees' Retirement Code and requires contributions by active members, the employer (State System), and the Commonwealth of Pennsylvania. Contribution rates for most active members are between 5.25% and 7.50% of their qualifying compensation, depending upon when the active member was hired and what benefits class was selected. New members hired after July 1, 2011, have a one-time election to choose a 10.3% contribution rate. The contribution rate for the State System is an actuarially determined rate. The rate was 8.465% of annual covered payroll at June 30, 2014. The State System's contributions to PSERS for the years ended June 30, 2014, 2013, and 2012, were $3,940,000, $2,752,000, and $1,769,000, respectively, equal to the required contractual contribution. PSERS issues a comprehensive annual financial report that includes financial statements and required supplementary information for the plan. A copy of the report may be obtained from the Publications page of the PSERS website, www.psers.state.pa.us, or by writing to Public School Employees' Retirement System, 5 North Fifth Street, Harrisburg, PA 17101-1905.

SERS provides retirement, death, and disability benefits, and legislative mandated ad hoc cost-of-living adjustments. Article II of the Commonwealth of Pennsylvania's Constitution assigns the authority to establish and amend the benefits provisions of the plan to the General Assembly. The contribution policy for SERS, as established by the State Employees' Retirement Code, requires contributions by active members and the employer (State System). The contribution rate for both active members and the State System depends upon when the active member was hired and what benefits class is selected. Contribution rates for most active members are between 5.0% and 6.25% of their qualifying compensation. New members hired after January 1, 2011, have a one-time election to choose a 9.3% contribution rate. The State System contributed at actuarially determined rates of between 10.46% and 15.12% of active members' annual covered payroll at June 30, 2014. The State System's contributions to SERS for the years ended June 30, 2014, 2013, and 2012, were $43,548,000, $30,490,000, and $20,643,000, respectively, equal to the required contractual contribution. SERS issues a publicly available annual financial report that includes financial statements and required supplementary information for the plan. A copy of the report may be obtained from the SERS website, www.sers.state.pa.us, or by writing to Commonwealth of Pennsylvania, State Employees' Retirement System, 30 North Third Street, Suite 150, Harrisburg, PA 17101.

Because the ARP is a defined contribution plan, benefits equal amounts contributed to the plan plus investment earnings. Act 188 empowers the Board to establish and amend benefits provisions. The State Employees' Retirement Code establishes the employer contribution rate for the ARP, while the Board establishes the employee contribution rates. Active members contribute at a rate of 5% of their qualifying compensation. The State System's contribution rate on June 30, 2014 and 2013, was 9.29% of qualifying compensation. The contributions to the ARP for the years ended June 30, 2014 and 2013, were $43,869,000 and $43,080,000, respectively, from the State System; and $23,802,000 and $23,633,000, respectively, from active members.

(5) Postretirement Benefits

State System employees who retire after meeting specified service and age requirements become eligible for participation in one of two defined health care benefits plans, referred to here as the *System Plan* and the *Retired Employees Health Program*. These plans include hospital, medical/surgical, and major medical coverage, and provide a Medicare supplement for individuals over age 65.

System Plan

Plan Description

Employee members of the Association of Pennsylvania State College and University Faculties (APSCUF), the State College and University Professional Association (SCUPA), Security Police and Fire Professionals of America (SPFPA), Pennsylvania Nurses Association (PNA), and nonrepresented employees participate in a single-employer defined benefits health care plan administered by the State System (System Plan). The System Plan provides eligible retirees and their eligible dependents with health care benefits and tuition waivers at any of the 14 State System universities. Act 188 empowers the Board to establish and amend benefits provisions. The System Plan has no plan assets and no financial report is prepared.

Funding Policy
The contribution requirements of plan members and the State System are established and may be amended by the Board. The System Plan is funded on a pay-as-you-go basis; i.e., premiums are paid to an insurance company and various health maintenance organizations to fund the health care benefits provided to current retirees. Tuition waivers are provided by the retiree's sponsoring university as they are granted. The State System paid premiums of $44,201,000 and $42,975,000 for the fiscal years ending June 30, 2014 and 2013, respectively. Plan members receiving benefits contribute at various rates, depending upon when they retire, whether they are eligible for Medicare, the contribution rate in effect on the day of their retirement, the contribution rate for active employees, and applicable collective bargaining agreements. Following are the contribution rates of plan members as of June 30, 2014.

- Eligible plan members receiving benefits who retired prior to July 1, 2005, are not required to make contributions.
- Nonfaculty coaches who retired on or after July 1, 2005, pay a percentage of their final annual gross salary at the time of retirement.
- Other eligible annuitants who retired on or after July 1, 2005, and prior to July 1, 2008, and who are under age 65 pay 10% of the plan premium in effect on the day of retirement. When these annuitants become eligible for Medicare, they pay 15% of the current cost of their Medicare coverage and current cost of coverage for covered dependents. The rate changes annually, and future adjustments will apply if contributions increase for active employees.
- Other eligible annuitants who retire on or after July 1, 2008, pay 15% of the plan premium in effect on their retirement date. Future adjustments will apply if contributions increase for active employees.

Total contributions made by plan members were $3,969,000 and $3,607,000, or approximately 8.2% and 7.7% of the total premiums, for the fiscal years ending June 30, 2014 and 2013, respectively.

Annual OPEB Cost and Net OPEB Obligation
The State System's annual other postemployment benefit (OPEB) cost is calculated based on the annual required contribution (ARC) of the employer, an amount actuarially determined in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. The ARC represents a level of funding that, if paid annually, is projected to cover normal cost plus the annual portion of the unfunded actuarial liability amortized over 30 years. The following shows the components of the State System's annual OPEB cost for the year, the amount actually contributed to the plan, and changes in the State System's net OPEB obligation.

(in thousands)	June 30, 2014	June 30, 2013
Annual required contribution	$127,861	$120,129
Interest on net OPEB obligation	39,257	36,737
Adjustment to ARC	(49,536)	(44,596)
Annual OPEB cost (expense)	117,582	112,270
Contributions made	(44,201)	(42,975)
Increase in net OPEB obligation	73,381	69,295
Net OPEB obligation at July 1	933,690	864,395
Net OPEB obligation at June 30	$1,007,071	$933,690

The State System's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for June 30, 2014, and the two preceding years were as follows.

(in thousands)

Fiscal Year Ended	**Annual OPEB Cost**	**Percentage of Annual OPEB Cost Contributed**	**Net OPEB Obligation**
June 30, 2012	$111,672	34.7%	$864,395
June 30, 2013	$112,270	38.3%	$933,690
June 30, 2014	$117,582	37.6%	$1,007,071

Funded Status and Funding Progress
The funded status of the plan as of July 1, 2013, the most recent actuarial valuation date, was as follows.

(in thousands)	
Actuarial accrued liability (AAL)	$1,473,632
Actuarial value of plan assets	0
Unfunded actuarial accrued liability (UAAL)	$1,473,632
Funded ratio (actuarial value of plan assets/AAL)	0%
Covered payroll (active plan members)	$583,755
UAAL as a percentage of covered payroll	252%

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the health care cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

Actuarial Methods and Assumptions
Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefits costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

In the July 1, 2012, actuarial valuation, the projected unit credit method was used. The actuarial assumptions included a 4.25% investment rate of return, which is the expected rate to be earned on the State System's operating portfolio, and annual health care cost trend rates of 7.8% for pre-Medicare and 6.8% for post-Medicare initially, reduced by decrements to an ultimate rate of 5.0% by 2025. The UAAL is being amortized as a level percentage of payroll on a closed basis. The remaining amortization period at July 1, 2013, was 22 years.

Retired Employees Health Program

Plan Description
Employee members of the American Federation of State, County and Municipal Employees (AFSCME), Pennsylvania Doctors Alliance (PDA), and Pennsylvania Social Services Union (PSSU) participate in the Retired Employees Health Program (REHP), which is sponsored by the Commonwealth and administered by the Pennsylvania Employee Benefits Trust Fund (PEBTF). The REHP provides eligible retirees and their eligible dependents with health care benefits. Benefits provisions are established and may be amended under pertinent statutory authority. The REHP neither issues a stand-alone financial report nor is it included in the report of a public employee retirement system or other entity.

Funding Policy
The contribution requirements of plan members covered under collective bargaining agreements are established by the collective bargaining agreements. The contribution requirements of nonrepresented plan members and contributing entities are established and may be amended by the Commonwealth's Office of Administration and the Governor's Budget Office. Plan members who enrolled prior to July 1, 2005, are not required to make contributions. Plan members who enrolled after July 1, 2005, contribute a percentage of their final salary, the rate of which varies based on the plan member's enrollment date. Agency member (employer) contributions are established primarily on a pay-as-you-go basis. In fiscal year 2013/14, the State System contributed $305 for each current active employee per biweekly pay period. The State System made contributions of $28,584,000, $25,638,000, and $23,228,000 for the fiscal years ending June 30, 2014, 2013, and 2012, respectively, equal to the required contributions for the year. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or

decreasing over time relative to the actuarial accrued liabilities for benefits.

(6) Workers' Compensation

The State System is self-insured for workers' compensation losses. For claims occurring prior to July 1, 1995, State System universities must pay up to $100,000; for claims occurring on or after July 1, 1995, State System universities must pay up to $200,000. Claims in excess of the self-insurance limits are funded through the Workers' Compensation Collective Reserve Fund (Reserve Fund), to which all State System universities contribute an amount determined by an independent actuarial study. Based on updated actuarial studies, the universities contributed $1,875,000 and $1,854,000 to the Reserve Fund during the years ended June 30, 2014 and 2013, respectively.

For the years ended June 30, 2014 and 2013, the aggregate liability for claims under the self-insurance limit was $9,902,000 and $10,650,000, respectively. The Reserve Fund assets of $11,808,000 and $10,694,000 are equal to the liability for claims in excess of the self-insurance limits for the years ended June 30, 2014 and 2013, respectively. Changes in the workers' compensation claims liability in fiscal years 2014 and 2013 follow.

(in thousands)

Year	Beginning Balance	Current Year Claims and Changes in Estimates	Claim Payments	Ending Balance
2013	$19,763	$5,921	$4,340	$21,344
2014	$21,344	$5,244	$4,878	$21,710

(7) Compensated Absences

Changes in the compensated absences liability in fiscal years 2014 and 2013 are as follows.

(in thousands)

Year	Beginning Balance	Current Changes in Estimates	Less Payouts	Ending Balance
2013	$108,206	$11,887	$10,184	$109,909
2014	$109,909	$11,536	$6,735	$114,710

(8) Bonds Payable

Bonds payable on June 30, 2014 and 2013, consisted of several outstanding tax-exempt revenue bond series issued by the Pennsylvania Higher Educational Facilities Authority (PHEFA). In connection with the bond issuance, the State System entered into a loan agreement with PHEFA under which the State System has pledged its full faith and credit for the repayment of the bonds. The loan constitutes an unsecured general obligation of the State System. The bonds were issued to provide funds to undertake various capital projects at the universities or to advance refund certain previously issued bonds.

In May 2014, the net proceeds from the Series AP revenue bonds were used to current refund Series Z and AA bonds. This refunding was performed to reduce debt service by approximately $6,448,000 and resulted in an economic gain (difference between the present values of the old and new debt service payments) of approximately $5,833,000.

(9) Rating Actions

The State System's outstanding bonds are assigned an Aa3 rating from Moody's Investors Service, Inc. In April 2014, Moody's revised the State System's outlook from *stable* to *negative*. The State System's outstanding bonds are assigned an AA rating from Fitch Ratings. In April 2014, Fitch also revised the State System's outlook from *stable* to *negative*.

Activity for the various bond series for the years ended June 30, 2014 and 2013, was as follows.

Bonds Payable
June 30, 2014 and 2013
(in thousands)

Description	Original Issuance	Weighted Average Interest Rate	Balance June 30, 2012	2013 Bonds Issued	2013 Bonds Redeemed/ Refunded	Balance June 30, 2013	2014 Bonds Issued	2014 Bonds Redeemed/ Refunded	Balance June 30, 2014	Current Portion
Series Z issued March 2004, final maturity June 2024	$71,760	4.04%	$41,230	-	$1,930	$39,300	-	$39,300	-	-
Series AA issued July 2004, final maturity June 2024	28,750	4.65%	17,450	-	1,665	15,785	-	15,785	-	-
Series AC issued July 2005, final maturity June 2025	52,650	4.88%	36,580	-	2,675	33,905	-	2,810	$31,095	$2,945
Series AE issued July 2006, final maturity June 2036	103,290	4.97%	83,670	-	3,835	79,835	-	4,030	75,805	4,240
Series AF issued July 2007, final maturity June 2037	68,230	5.00%	58,825	-	2,105	56,720	-	2,195	54,525	2,305
Series AG issued March 2008, final maturity June 2024	101,335	4.87%	81,900	-	4,395	77,505	-	7,000	70,505	10,875
Series AH issued July 2008, final maturity June 2038	140,760	4.69%	126,855	-	3,830	123,025	-	4,020	119,005	4,220
Series AI issued August 2008, final maturity June 2025	32,115	4.15%	25,235	-	1,725	23,510	-	1,785	21,725	1,845
Series AJ issued July 2009, final maturity June 2039	123,985	4.89%	114,025	-	4,225	109,800	-	4,515	105,285	4,835
Series AK issued Sept. 2009, final maturity June 2024	47,310	3.88%	39,525	-	3,580	35,945	-	3,705	32,240	3,795
Series AL issued July 2010, final maturity June 2035	135,410	5.00%	123,585	-	7,705	115,880	-	25,815	90,065	7,710
Series AM issued July 2011, final maturity June 2036	119,085	4.67%	116,025	-	3,865	112,160	-	3,990	108,170	4,200
Series AN issued March 2012, final maturity June 2023	76,810	5.00%	76,810	-	375	76,435	-	1,070	75,365	4,000
Series AO issued July 2013, final maturity June 2038	30,915	4.25%	-	-	-	-	$30,915	920	29,995	1,040
Series AP issued May 2014, final maturity June 2024	46,110	4.20%	-	-	-	-	46,110	-	46,110	2,685
Total	**$1,178,515**	**-**	**$941,715**	**-**	**$41,910**	**$899,805**	**$77,025**	**$116,940**	**$859,890**	**$54,695**

Principal and interest requirements to maturity are as follows.

(in thousands)	Principal	Interest	Total
2015	$54,695	$41,053	$95,748
2016	61,025	38,303	99,328
2017	62,560	35,408	97,968
2018	61,475	32,381	93,856
2019	64,985	29,437	94,422
2020–2024	301,900	102,137	404,037
2025–2029	152,420	44,189	196,609
2030–2034	77,515	15,368	92,883
2035–2039	23,315	2,267	29,582
Total	**$859,890**	**$340,543**	**$1,200,433**

(10) Capital Assets

The classifications of capital assets and related depreciation at June 30, 2014 and 2013, follow.

(in thousands)

	Balance June 30, 2012	**2012/13 Additions**	**2012/13 Retirements/ Adjustments**	**Balance June 30, 2013**	**2013/14 Additions**	**2013/14 Retirements/ Adjustments**	**Balance June 30, 2014**
Land	$27,606	$1,657	-	$29,263	$2,954	$143	$32,360
Construction in progress	92,627	65,413	($54,258)	103,782	56,997	(90,573)	70,206
Total capital assets not being depreciated	120,233	67,070	(54,258)	133,045	59,951	(90,430)	102,566
Buildings, including improvements	1,888,922	39,741	24,604	1,953,267	31,516	55,017	2,039,800
Improvements other than buildings	232,226	6,516	3,720	242,462	8,159	13,877	264,498
Equipment and furnishings	425,040	24,688	(4,297)	445,431	19,135	(9,809)	454,757
Library books	83,960	1,331	(1,380)	83,911	1,181	(1,402)	83,690
Total capital assets being depreciated	2,630,148	72,276	22,647	2,725,071	59,991	57,683	2,842,745
Less accumulated depreciation							
Buildings and improvements	(637,152)	(76,504)	10,046	(703,610)	(79,062)	5,417	(777,255)
Land improvements	(103,520)	(9,194)	435	(112,279)	(9,721)	416	(121,584)
Equipment and furnishings	(313,735)	(31,589)	6,238	(339,086)	(29,276)	12,996	(355,366)
Library books	(72,587)	(2,249)	1,270	(73,566)	(2,134)	1,402	(74,298)
Total accumulated depreciation	(1,126,994)	(119,536)	17,989	(1,228,541)	(120,193)	20,231	(1,328,503)
Total capital assets being depreciated, net	1,503,154	(47,260)	40,636	1,496,530	(60,202)	77,914	1,514,242
Capital assets, net	$1,623,387	$19,810	($13,622)	$1,629,575	($251)	($12,516)	$1,616,808

(11) Contingencies and Commitments

Contingencies

The nature of the educational industry is such that, from time to time, the State System is exposed to various risks of loss related to torts; alleged negligence; acts of discrimination; breach of contract; labor disputes; disagreements arising from the interpretation of laws or regulations; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. While some of these claims may be for substantial amounts, they are not unusual in the ordinary course of providing educational services in a higher education system.

The State System receives support from federal and Commonwealth grant programs, primarily for student financial assistance. Entitlement to the resources requires compliance with terms of the grant agreements and applicable regulations, including the expenditure of the resources for eligible purposes. Substantially all grants are subject to financial and compliance audits by the grantors. As of June 30, 2014, the State System estimates that adjustments, if any, as a result of such audits would not have a material adverse effect on the accompanying financial statements.

The State System is self-insured for workers' compensation up to stated limits (note 6). For all other risks of loss, the State System pays annual premiums to the Commonwealth to participate in its Risk Management Program. The State System does not participate in any public entity risk pools, and does not retain risk related to any aforementioned exposure, except for those amounts incurred relative to policy deductibles that are not significant. The State System has not significantly reduced any of its insurance coverage from the prior year. Settled claims have not significantly exceeded the State System's insurance coverage in any of the past three years. It is not expected that the resolution of any outstanding claims and litigation will have a material adverse effect on the accompanying financial statements.

Construction Commitments

Authorized expenditures for construction projects unexpended as of June 30, 2014 and 2013, were approximately $75,162,000 and $58,155,000, respectively.

REQUIRED SUPPLEMENTARY INFORMATION
Years Ended June 30, 2014 and 2013
(Unaudited)

Schedule of Funding Progress for the System Plan (OPEB)
(in thousands)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ([b-a]/c)
July 1, 2011	$0	$1,373,049	$1,373,049	0%	$570,839	241%
July 1, 2012	$0	$1,420,502	$1,420,502	0%	$566,753	251%
July 1, 2013	$0	$1,473,632	$1,473,632	0%	$583,755	252%

Schedule of Funding Progress for the REHP (OPEB)
(in thousands)

The information below relates to the Commonwealth's REHP as a whole, i.e., it is inclusive of all participating Commonwealth agencies and instrumentalities. Nearly all Commonwealth agencies and instrumentalities participate in the REHP.

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ([b-a]/c)
July 1, 2011	$70,740	$12,907,790	$12,837,050	.55%	$3,839,000	334%
July 1, 2012	$71,630	$12,843,700	$12,772,070	.56%	$4,130,000	309%
July 1, 2013	$82,060	$13,234,040	$13,151,980	.62%	$4,264,000	308%

[THIS PAGE INTENTIONALLY LEFT BLANK]

Pennsylvania's State System of Higher Education
Office of the Chancellor
Dixon University Center
2986 North Second Street
Harrisburg, PA 17110

717-720-4000 ★ www.passhe.edu