PENNSYLVANIA'S STATE SYSTEM OF HIGHER EDUCATION

Pennsylvania's
STATE SYSTEM
of Higher Education

FINANCIAL STATEMENTS
JUNE 30, 2016

Pennsylvania's State System of Higher Education
Financial Statements
June 30, 2016

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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 Pennsylvania's 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, 2016 and 2015, 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 opinions on these financial statements based on our audit. We did not audit the financial statements of certain of the discretely presented component units, which represent 85.5% percent, 94.7% percent, and 86.4% percent, respectively, of the 2016 assets, net assets, and revenues and 100% percent, 100% percent, and 100% percent, respectively, of the 2015 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 opinions.

Opinions

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 respective financial position of the business-type activities and the aggregate discretely presented component units of the State System as of June 30, 2016 and 2015, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

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 3-19, schedules of funding progress for OPEB on page 52, schedules of proportionate share of SERS/PSERS Net Pension Liability and SERS/PSERS schedules of contributions on page 53 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 28, 2016

MANAGEMENT'S DISCUSSION AND ANALYSIS
(Unaudited)

As the Commonwealth of Pennsylvania's (Commonwealth) public four-year higher education institutions, 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 more than 100,000 degree-seeking students enrolled, and thousands more enrolled in certificate and other career-development programs, the State System is the state's largest higher education provider. The 14 universities offer the lowest-cost four-year baccalaureate degree programs in the state, with more than 2,300 degree and certificate programs in more than 530 academic areas. 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

The universities operate branch campuses in Oil City (Clarion), Freeport and Punxsutawney (Indiana), and Clearfield (Lock Haven), and offer classes and programs at several regional centers, including the Dixon University Center in Harrisburg and Center City in Philadelphia.

Following is an overview of the State System's financial activities for the year ended June 30, 2016, as compared to the year ended June 30, 2015.

FINANCIAL HIGHLIGHTS
In fiscal year 2015/16, the State System received $433.4 million in General Fund **appropriations** from the Commonwealth, a 5% increase over the $412.8 million received in the last four fiscal years. The increase is the first received by the System since 2008/09, and it is $4.2 million less than the level of funding the State System received in fiscal year 1999/00—16 years ago.

The State System received a $15.3 million Realty Transfer Tax allocation from the Commonwealth's **Key '93** (Keystone Recreation, Park and Conservation) Fund, an increase of $1.9 million, or 14.2%, from fiscal year 2014/15. With the exception of fiscal years 2010/11 and 2009/10, when no funding was received, Key '93 funds have provided a consistent revenue stream for university deferred maintenance projects since 1993.

The State System was allocated $65 million in **Commonwealth capital funding**, primarily for renovation or replacement of existing educational and general (E&G) 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 in 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 in fiscal year 2016/17. The capital appropriations reflected in these statements represent the furnishings and equipment for the Commonwealth-funded construction projects and total $15.7 million and $13.6 million in fiscal years 2015/16 and 2014/15, 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 $38.5 million of the general appropriation for **performance funding** in fiscal year 2015/16, nearly 3% more than the $37.4 million allocated in fiscal year 2014/15. Performance funding allocated in fiscal year 2013/14 was $37.0 million.

Fall 2015 student headcount was 107,126, a decrease of 2,480 students, or 2.3%, from fall 2014. This is the fifth year in a row that the State System has experienced an **enrollment decline**. Fall 2011 was the first year enrollment had declined since 1999, following 14 years of record growth.

Year	Fall Enrollment	% Decrease from Prior Year
2015	107,126	2.3%
2014	109,606	2.2%
2013	112,028	2.1%
2012	114,471	3.2%
2011	118,224	1.0%

Despite the recent decline, the State System's fall enrollment has increased 35% since fall 1983, which was the first year of operation as a System.

Of the 107,126 **students** in the fall 2015 enrollment, 89,845 (84%) were full-time and 17,281 (16%) were part-time students; 92,818 (87%) were undergraduate and 14,308 (13%) were graduate students. These percentages of full- and part-time, graduate and undergraduate students are approximately the same as in fall 2014 and fall 2013.

In academic year 2014/15, the State System awarded 25,556 **degrees**, comprising 20,143 bachelor's degrees, 4,802 master's degrees, 196 doctoral degrees, and 415 associate's degrees. This is slightly up from the 25,516 degrees awarded in academic year 2013/14 and slightly down from the 25,635 degrees awarded in academic year 2012/13.

The Board approved an annual full-time **tuition rate increase** of $240 (3.5%) for undergraduate resident students in fiscal year 2015/16. This compares to an increase of $198 (3.0%) in fiscal year 2014/15. The State System's 2015/16 annual tuition rate of $7,060 for full-time, resident, undergraduate students is the lowest-cost option among all four-year colleges and universities in the state.

The Board approved **new tuition rates for resident graduate students and all nonresident students**. The typical resident graduate tuition rate in 2015/16 was $470 per credit, an increase of $16. Nonresident graduate tuition increased by $24 per credit to $705. Full-time, undergraduate tuition for nonresident students ranged from $10,590 to $17,650, 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 3.5%.

The Board approved a $14 increase to the **technology tuition fee (**$436 annually) for full-time resident undergraduate students and a $22 increase ($664 annually) for full-time nonresident undergraduate students. All funds raised by the technology tuition fee are used to directly benefit student learning. Universities have used the funds to install new computer labs and design multimedia classrooms, among other projects.

Mandatory student fees set by the universities increased, on average, by 4.4%. These increases, combined with the increase in tuition and reduction in enrollment, resulted in tuition and mandatory fee revenue (before discounts) of $1.09 billion, a 1.4% increase over fiscal year 2014/15. The average increase in mandatory student fees in fiscal year 2014/15 was 3.8% over the prior year.

Auxiliary revenue from **room and board fees** (excluding privatized housing revenue recorded by affiliates) was $265.5 million in fiscal year 2015/16, an increase of $0.2 million, or 0.1%, over fiscal year 2014/15. This compares to a fiscal year 2014/15 decrease of 2.0%, or $5.3 million, in room and board revenues over the prior fiscal year.

The State System's typical **price of attendance** (tuition, mandatory fees, room, and board) of $19,738 in 2015/16 was $190 above the average among all four-year public universities in the United States and $1,889 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 $190.8 million in **capital assets** in fiscal year 2015/16, including

$158.2 million to build or improve academic and auxiliary facilities across all 14 universities.

During fiscal year 2015/16, the State System issued Series AR bonds, totaling $102.4 million, to undertake various **capital projects** at the universities, comprising:

- $4.1 million for a steam plant upgrade and $6.0 million for new student housing at Bloomsburg;
- $71.8 million for acquisition of affiliate-owned student housing and $10.6 million for renovation of the student center at California; and
- $9.9 million for dining hall renovations at Millersville.

The State System also issued Series AS bonds, totaling $47.3 million, to provide funds to advance refund Series AF revenue bonds.

Bond principal of $57.7 million and bond interest of $41.7 million were paid, while $49.8 million of bonds were refunded, bringing the total outstanding **bond debt** to $842.6 million at June 30, 2016.

The State System's outstanding bonds are assigned an Aa3 rating from Moody's Investors Service, Inc. In August 2016, Moody's revised the outlook for the rating from *negative* to *stable*. Fitch Ratings reaffirmed the State System's rating of AA- with an outlook of *stable*.

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.

- *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 and certain items associated with the net pension liability and annual pension expense.

- *Liabilities* include payments due to vendors, employees, and students; revenues received but not yet earned; the balance of bonds payable; and amounts estimated to be due for items such as workers' compensation (the State System is self-insured), compensated absences (the value of sick and annual leave earned by employees), pension benefits, and other 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 and certain items associated with the net pension liability and annual pension expense.

- *Net Position*, colloquially 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.

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.

Statement of Cash Flows

The *Statement of Cash Flows* provides information about the State System's cash receipts and cash payments. It can 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 the corpus 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 includes three unfunded liabilities. Because these liabilities are expected to be realized gradually over future years, and because of their size, the universities fund them only as they become due.

  - The liability for **compensated absences** represents the dollar value of annual and sick leave that employees have earned and could potentially receive in the form of cash payouts upon retirement or other termination. The dollar value is based on an employee's current salary. All full-time employees are eligible to be paid, upon termination, for the dollar value of the number of days of unused annual, personal, and holiday leave that they have accumulated, with a maximum accumulation of 45 days; the associated liability is calculated based on the total number of days that employees have accumulated at June 30. Sick leave payouts, however, are subject to vesting requirements, and the dollar value of accumulated unused sick leave is paid only to those employees who meet certain service and/or age requirements and is capped at various levels depending upon the number of days accumulated. The associated liability is estimated based on a calculation of historical leave payouts for terminated employees compared to the dollar value of sick days that the terminated employees had accumulated, applied to employees' current leave balances.

    As employees earn and accumulate leave, the compensated absences liability is increased; as employees use leave, and as terminated employees receive payouts, the liability is decreased. The compensated absences liability increased by $0.8 million to $115.4 million for the year ended June 30, 2016, compared to a $0.1 million decrease from the prior year for the year ended June 30, 2015. Universities fund this liability only as cash payouts are made to employees for annual and vested sick leave balances upon termination or retirement.

  - The liability for **other postretirement benefits** represents the estimated future health care costs for current and future retirees who participate in the State System health care plan. The annual increase in the liability is the amount that current employees earn each fiscal year as a retiree health care benefit, actuarially calculated based on years of service, age, and estimates of future service and employee longevity. The liability also increases as health care costs increase. The liability decreases when required contributions by retirees are increased, when the number of eligible employees decrease, and when retirees die. The liability increased by $47.9 million to $1.10 billion for the year ended June 30, 2016. Universities fund this liability on a "pay-as-you-go" basis; that is, they make biweekly contributions to fund the actual claims made by retirees during the year.

  - The **net pension liability** is the State System's allocated share of the difference between the Commonwealth's defined benefit pension obligations and the funding set aside in a qualified trust to pay the future benefits that are promised to current employees, retirees, and their beneficiaries. The annual increase in the liability is the amount that current employees earn each fiscal year as a pension benefit, actuarially calculated based on years of service, age, and estimates of future service and employee longevity. The liability decreases when funding of the qualified trust increases and when employees or retirees leave the pension plans. The liability increased by $139.9 million to $938.6 million for the year ended June 30, 2016. Like the postretirement benefits liability, universities fund this liability on a "pay-as-you-go" basis with annual contractually required contributions to the State Employees Retirement System (SERS) and the Public School Employees Retirement System (PSERS).

Overall, net position decreased by $63.4 million in fiscal year 2015/16. This compares to a decrease from the prior year of $797.5 million in fiscal year 2014/15 (which included a $720.9 million net pension liability restatement), and a decrease of $52.8 million in fiscal year 2013/14 over fiscal year 2012/13.

Following is a summary of the balance sheet at June 30, 2016, 2015, and 2014.

(in millions)

Balance Sheet

	June 30, 2016	**Change from Prior Year**	**June 30, 2015**	**Change from Prior Year**	**June 30, 2014**	**Change from Prior Year**
Assets						
Cash and investments	$1,376.2	3.2%	$1,333.9	(2.1%)	$1,363.1	0.0%
Capital assets, net	1,653.3	4.0%	1,589.2	(1.7%)	1,616.8	(0.8%)
Other assets and deferred outflows	376.6	42.7%	263.9	42.8%	184.8	5.1%
Total assets and deferred outflows	$3,406.1	6.9%	$3,187.0	0.7%	$3,164.7	(0.1%)
Liabilities						
Workers' compensation	$22.1	(2.2%)	$22.6	4.1%	$21.7	1.9%
Compensated absences	115.4	0.7%	114.6	(0.1%)	114.7	4.4%
Postretirement benefits	1,106.6	4.5%	1,058.7	5.1%	1,007.1	7.9%
Net pension liability	938.6	17.5%	798.7	N/A	N/A	N/A
Bonds payable	842.6	5.3%	800.5	(6.9%)	859.9	(4.4%)
Other liabilities and deferred inflows	502.8	11.6%	450.4	6.7%	422.3	2.5%
Total liabilities and deferred inflows	3,528.1	8.7%	3,245.5	33.8%	2,425.7	2.1%
Net Position						
Net investment in capital assets	709.3	1.3%	700.3	2.3%	684.4	5.7%
Restricted	114.4	16.6%	98.1	(5.0%)	103.3	11.7%
Unrestricted	(945.7)	(10.4%)	(856.9)	(1,659.5%)	(48.7)	(194.4%)
Total net position	(122.0)	(108.5%)	(58.5)	(107.9%)	739.0	(6.7%)
Total liabilities, deferred inflows, and net position	$3,406.1	6.9%	$3,187.0	0.7%	$3,164.7	(0.1%)

Revenues and Gains
Following is a summary of revenues and gains for the years ending June 30, 2016, 2015, and 2014.

(in millions)

Revenues and Gains

	June 30, 2016	Change from Prior Year	June 30, 2015	Change from Prior Year	June 30, 2014	Change from Prior Year
Operating revenues						
Tuition and fees, net	$839.0	2.7%	$816.6	0.9%	$809.3	0.6%
Grants and contracts	155.5	3.2%	150.7	(6.3%)	160.8	1.8%
Auxiliary enterprises, net	323.4	(0.2%)	324.0	(2.2%)	331.4	(0.5%)
Other	46.1	(12.4%)	52.6	(1.1%)	53.2	19.6%
Total operating revenues	1,364.0	1.5%	1,343.9	(0.8%)	1,354.7	1.1%
Nonoperating revenues and gains						
State appropriations	449.1	5.3%	426.4	(0.2%)	427.1	(0.1%)
Investment income, net	24.0	(22.6%)	31.0	18.3%	26.2	28.4%
Unrealized gain on investments	2.6	-	-	-	-	-
Gifts, nonoperating grants, and other	186.7	6.9%	174.6	4.3%	167.4	(2.6%)
Total nonoperating revenues and gains	662.4	4.8%	632.0	1.8%	620.7	0.1%
Total revenues and gains	$2,026.4	2.6%	$1,975.9	-	$1,975.4	0.8%

Overall, fiscal year 2015/16 **operating revenues** increased by 1.5% from the prior fiscal year. Nonoperating revenues increased by 4.8%, for an overall increase in revenues and gains of 2.6%.

Tuition and fees are shown net of scholarship discounts and allowances and bad debt expense. 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 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. Bad debt expense is an estimate of the amount owed by students that will not be collected.

Despite the decline in enrollment, overall net tuition and fee revenue increased by $22.4 million, or 2.7%, over fiscal year 2014/15. This can be attributed to both the increase in the tuition and fee rates and to the continuing execution of 25 new flexible tuition pricing programs, which began to be implemented in fiscal year 2013/14. These pilot programs are designed to address the unique market conditions that affect each of the universities and will be evaluated over a two- or three-year period to determine their effectiveness as well as whether they should be duplicated at other universities.

Auxiliary enterprises revenue, which includes food service sales, housing fees, and fees for the operation, maintenance, debt service, and renewal of student union and recreation centers, decreased by $0.6 million from fiscal year 2014/15. The overall decrease is due to several factors:

- The combination of **university housing fees** and **privatized housing fees** increased in fiscal year 2015/16 over fiscal year 2014/15 by $1.5 million, or 1.1%, to a total of $135.2 million. This compares to a decrease of $8.1 million, or 5.7%, in fiscal year 2014/15 over fiscal year 2013/14. The privatized housing fees result from the privatized housing contracts in which the universities manage the operations on behalf of their affiliates. The fees are used to cover associated expenses, capital expenditures, and debt service, and include some form of profit-sharing between the universities and their respective affiliates.

- The revenue that universities record as university housing fees, versus the revenue recorded as privatized housing fees, is fluctuating, as some universities begin to convert their affiliates' privatized housing into university housing while others have expanded the use of privatized housing. In fiscal year 2015/16, California University acquired all six of the student residence halls on campus property that had been constructed by their affiliate, Student Association, Incorporated, while Clarion and Millersville Universities expanded their privatized housing. In fiscal year 2016/17, Edinboro, Lock Haven, and Mansfield Universities will complete the acquisition of privatized housing from their affiliates.

- Several universities have privatized housing contracts that do not involve the universities in the management of housing operations but primarily provide for **ground lease fees** to be paid to the universities by affiliates who have constructed the housing on university- or Commonwealth-owned land. The universities record these ground lease fees, which totaled $2.1 million in fiscal year 2015/16, as E&G, rather than Auxiliary, revenue. Universities recorded $2.9 million in ground lease fees in E&G in fiscal year 2014/15. The fiscal year 2015/16 decrease reflects contract provisions that vary the amount of the ground lease fees over the term of the agreements.

- **Food service sales** declined by $1.3 million, or 1.0%, in fiscal year 2015/16 over fiscal year 2014/15, compared to an increase of $2.8 million, or 2.2%, in fiscal year 2014/15 over the prior year. Most universities saw relatively small decreases in food service revenue in fiscal year 2015/16, while some had relatively small increases, and the overall decline can be attributed at least in part to the decline in enrollment.

- **Fees for student union and recreation centers** have been increasing slightly, with revenues of $47.4 million, $47.3 million, and $46.7 million recorded in fiscal years 2015/16, 2014/15, and 2013/14, respectively.

State appropriations include cash as well as capital appropriations that are received in the form of noncash furnishings and equipment for the Commonwealth-funded construction projects. The fiscal year 2015/16 general cash appropriation was $433.4 million, a $20.6 million increase over fiscal year 2014/15, while noncash capital appropriations were $15.7 million, a $2.1 million increase over fiscal year 2014/15.

Investment income (net of related investment expenses) for fiscal year 2015/16 was $24.0 million. This represents a decrease of $7.0 million from the prior year. The decrease is due in part to the delayed receipt of the first five months of appropriations, totaling $219.4 million, which were not released to the State System until January 2016. In addition, the reimbursement bond investment portfolio, which is dedicated to pay associated debt service, experienced a decrease of approximately $7.8 million of investment earnings from the prior year, primarily due to the timing in the schedule of maturing securities. Interest rates, which rose slightly in the first half of the fiscal year, remained flat during the second half.

Expenses and Losses
Following is a summary of expenses and losses for the years ending June 30, 2016, 2015, and 2014.

(in millions)

Expenses and Losses

	June 30, 2016	Change from Prior Year	June 30, 2015	Change from Prior Year	June 30, 2014	Change from Prior Year
Operating expenses						
Instruction	$749.3	1.3%	$739.6	2.6%	$721.0	2.3%
Research	6.3	8.6%	5.8	13.7%	5.1	(5.6%)
Public service	39.4	5.1%	37.5	-	37.5	9.6%
Academic support	184.0	2.7%	179.1	4.2%	171.9	0.6%
Student services	184.7	2.0%	181.0	2.5%	176.6	3.7%
Institutional support	257.2	3.5%	248.5	(5.9%)	264.0	2.3%
Operations and maintenance of plant	159.9	4.2%	153.5	0.8%	152.3	6.4%
Depreciation	121.7	1.7%	119.7	(0.4%)	120.2	0.6%
Student aid	79.1	8.5%	72.9	(3.6%)	75.6	1.5%
Auxiliary enterprises	253.8	(0.7%)	255.7	1.5%	251.8	3.5%
Total operating expenses	2,035.4	2.1%	1,993.3	0.9%	1,976.0	2.7%
Other expenses and losses						
Interest expense on capital asset-related debt	33.9	(7.4%)	36.6	(0.8%)	36.9	(2.6%)
Loss on disposal/acquisition of assets	20.5	113.5%	9.6	20.7%	12.1	92.1%
Unrealized loss on investment	-	-	13.1	309.4%	3.2	(37.3%)
Total other expenses and losses	54.4	(8.3%)	59.3	13.6%	52.2	5.7%
Total expenses and losses	$2,089.8	1.8%	$2,052.6	1.2%	$2,028.2	2.8%

Universities spent $749.3 million on **instruction**, or 36.8% of total operating expenses, in fiscal year 2015/16. This represents an increase of $9.7 million, or 1.3%, over fiscal year 2014/15.

Financial aid to students in the form of grants, waivers, and scholarships was $299.4 million in fiscal year 2015/16. In accordance with a formula prescribed by the National Association of College and University Business Officers (NACUBO), in fiscal year 2015/16 the State System reported $219.9 million of financial aid as *discounts,* which are netted against tuition and fees, and $79.5 million as *student aid*, which is reported as an expense. Of these amounts, $1.2 million of discounts and $0.4 million of student aid expense were reported in Auxiliary enterprises.

Including the financial aid that is recorded as a discount against tuition and fees, financial aid decreased in fiscal year 2015/16 by $1.1 million from the previous year. The drop is attributed to a $7.0 million decrease in Federal Pell grants, while all other financial aid increased by a total of $5.9 million. Following is the breakdown of financial aid in fiscal years 2015/16 and 2014/15.

(in millions)

Student Financial Aid

	2015/16	2014/15
Federal Pell grants	$138.6	$145.6
Other federal aid	5.2	5.0
State financial aid including PHEAA grants	93.0	91.5
Local government financial aid	2.6	1.5
Scholarships from endowments and restricted gifts and grants	17.0	16.4
Unrestricted scholarships and fellowships	10.0	10.6
Tuition and fee waivers	31.4	28.5
Housing and dining waivers	1.6	1.4
Total	$299.4	$300.5

Interest expense on capital asset-related debt was $33.9 million, a decrease of $2.7 million over fiscal year 2014/15, even though bonds payable increased by $42.1 million in fiscal year 2015/16 over 2014/15. The decrease in interest expense is primarily because the State System has been annually refunding debt with debt that carries lower interest rates. In addition, the older, more expensive, debt is being amortized at a faster rate, as a higher ratio of debt service is being applied to principal rather than interest.

Salaries and benefits totaled $1.4 billion in fiscal year 2015/16. Salary and wage expenses decreased by $11.6 million, or 1.3%, while benefits expenses increased by $39.1 million, or 8.1%, over fiscal year 2014/15, for an overall increase of $27.5 million. Following is a summary of salaries, wages, and benefits expenses for the years ending June 30, 2016, 2015, and 2014.

(in millions)

Salaries, Wages, and Benefits

	June 30, 2016	Change from Prior Year	June 30, 2015	Change from Prior Year	June 30, 2014	Change from Prior Year
Salaries and wages	$880.4	(1.3%)	$892.0	1.4%	$879.5	1.2%
Benefits						
Employee health care	128.5	5.4%	121.9	3.4%	117.9	8.6%
Health & Welfare Fund	8.6	2.4%	8.4	(5.6%)	8.9	7.2%
Postretirement health care	125.0	4.8%	119.3	(18.4%)	146.2	6.0%
SERS	104.0	24.6%	83.5	92.0%	43.5	42.6%
PSERS	16.0	138.8%	6.7	71.8%	3.9	39.3%
Alternative Retirement Plan (ARP)	43.9	(1.6%)	44.6	1.6%	43.9	1.9%
Other benefits	97.2	(2.5%)	99.7	5.4%	94.6	(2.3%)
Total benefits	523.2	8.1%	484.1	5.5%	458.9	7.2%
Total salaries, wages, and benefits	$1,403.6	2.0%	$1,376.1	2.8%	$1,338.4	3.2%

The decrease in **salaries and wages** primarily is attributed to a 1.1% reduction in total salaried complement in fiscal year 2015/16 from fiscal year 2014/15. Total salaried complement, which includes both permanent and temporary employees but excludes wage employees, was 12,179 in fall 2015, compared to 12,316 in fall 2014, a reduction of 137 employees. Since fall 2010, when total salaried complement was 12,749, the State System has reduced staff by 4.5%, or 570 employees.

Despite the decrease in total salaried complement, employer share of **employee health care costs**, including the Health & Welfare Fund, increased $6.8 million over fiscal year 2014/15, for a total increase of 5.2%. This follows consecutive increases of 2.8% ($3.5 million) and 8.5% ($9.9 million) in fiscal years 2013/14 and 2012/13, respectively, over the prior fiscal years. The increases are directly attributed to rising health care costs as well as employees' increasing use of health benefits.

The **postretirement health care** expense comprises:

- Premium payments to the Retired Employees Health Program (REHP), which is administered by the Commonwealth's Pennsylvania Employee Benefits Trust Fund (PEBTF);
- Claims paid to the third-party vendor for the plan administered by the State System (System Plan); and
- The actuarially calculated expense for the System Plan, in excess of claims paid, to recognize the current year increase in the long-term liability for future benefits expected to be paid from the System Plan for current and future retirees.

(in millions)

Postretirement Health Care

	2015/16	2014/15	2013/14
REHP premiums paid	$37.0	$30.7	$28.6
System Plan claims paid	40.1	36.9	44.2
System Plan actuarially calculated expense in excess of claims paid	47.9	51.7	73.4
Total	$125.0	$119.3	$146.2

The annual **REHP premiums** increased 20.5% ($6.3 million) in fiscal year 2015/16 over 2014/15, following an increase of 7.3% ($2.1 million) in fiscal year 2014/15 over 2013/14. The contribution rate is set at the discretion of the Commonwealth and generally is not known in advance. The State System currently does not record a liability for future benefits related to the REHP plan, but will be required to do so beginning in fiscal year 2017/18 in accordance with GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. The amount of the liability is not known but is expected to be significant.

The monthly cash payments made to a third-party health insurance vendor for the **System Plan** are based on estimates of retiree health care claims that are agreed to by the State System and the third-party vendor and are adjusted in the following year for the actual claims paid on behalf of retirees. The State System has seen flat or declining health care spending from retirees for the last several years, and increases are attributed to the increasing population of retirees and rising health care costs rather than the increase in benefits usage by retirees.

Following is a schedule of postretirement medical benefits annual payments, expense, and liability for the years ending June 30, 2016, 2015, and 2014, for the System Plan.

(in millions)

System Plan Postretirement Medical Benefits (referred to as Other Postemployment Benefits or OPEB)

	June 30, 2016	**Change from Prior Year**	**June 30, 2015**	**Change from Prior Year**	**June 30, 2014**	**Change from Prior Year**
Claims paid ("pay-as-you-go")	$40.1	8.7%	$36.9	(16.6%)	$44.2	2.9%
Annual OPEB cost (actuarial expense reported)	$88.0	(0.7%)	$88.5	(24.7%)	$117.6	4.7%
Net OPEB obligation (liability reported on the balance sheet)	$1,106.6	4.5%	$1,058.7	5.1%	$1,007.1	7.9%
Accrued actuarial liability (total liability as estimated by actuaries)	$1,194.8	-	$1,194.8	(18.9%)	$1,473.6	3.7%

- **Employer contributions to SERS**, a defined benefits pension plan, increased 20.6% over fiscal year 2014/15, for a total increase of $11.8 million. This follows consecutive increases of 31.4% ($13.7 million) and 42.6% ($13.0 million) in fiscal years 2014/15 and 2013/14, respectively, over the prior fiscal years. The increases were instituted by SERS to fund its net pension liability, which was $18.2 billion at December 31, 2015, a $3.3 billion increase from the $14.9 billion net pension liability reported at December 31, 2014. Approximately 40% of the State System's employees are enrolled in SERS.

- **Employer contributions to PSERS**, a defined benefits pension plan, increased 15.4% over fiscal year 2014/15, for a total increase of $0.8 million. This follows consecutive increases of 32.9% ($1.3 million) and 39.3% ($1.1 million) in fiscal years 2014/15 and 2013/14, respectively, over the prior fiscal years. The increases were instituted by PSERS to fund its net pension liability, which was $43.3 billion at June 30, 2015, up from the $39.6 billion net pension liability reported at June 30, 2014. Since approximately only 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. The Commonwealth makes annual pension contributions to PSERS on behalf of State System employees at the same annual rate.

- **Employer contributions to the ARP** (Alternative Retirement Plan), a defined contribution plan, decreased 1.6% over fiscal year 2014/15, for a total decrease of $0.7 million. This follows consecutive increases of 1.7% ($0.7 million) and 1.9% ($0.8 million) in fiscal years 2014/15 and 2013/14, respectively, over the prior fiscal years. The changes in annual contributions are attributed to fluctuating employee participation and salary increases. 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.

Following is a summary of pension benefits annual contributions, expense, and liability for the years ending June 30, 2016, 2015, and 2014.

(in millions)

Pension Benefits

	June 30, 2016	**Change from Prior Year**	**June 30, 2015**	**Change from Prior Year**	**June 30, 2014**	**Change from Prior Year**
Employer contributions						
SERS	$69.0	20.6%	$57.2	31.4%	$43.5	42.6%
PSERS	$6.0	15.4%	$5.2	32.9%	$3.9	39.3%
ARP	$43.9	(1.6%)	$44.6	1.7%	$43.9	1.9%
Pension expense						
SERS	$104.0	24.6%	$83.5	92.0%	$43.5	42.6%
PSERS	$16.0	138.8%	$6.7	71.8%	$3.9	39.3%
ARP	$43.9	(1.6%)	$44.6	1.7%	$43.9	1.9%
Net pension liability						
SERS	$858.4	17.9%	$728.1	7.4%	$677.9	Not calculated
PSERS	$80.2	13.4%	$70.7	(0.4%)	$71.0	Not calculated
ARP	$0.0	-	$0.0	-	$0.0	-

- The cost for **all other employee benefits**, such as Social Security and workers' compensation, decreased by a total of $2.5 million, or 2.5% less than fiscal year 2014/15, compared to a fiscal year 2014/15 increase of $5.1 million, or 5.4%, over fiscal year 2013/14. The decreases can be attributed to the decrease in the number of employees.

Future Economic Factors

The **Commonwealth** ended fiscal year 2015/16 with General Fund collections that were $29.9 million, or 0.1%, more than estimated. The Commonwealth budget, which is highly dependent on a growing economy, faces continued challenges, such as increasing pension obligations, wages and benefits, debt service, and medical and entitlement costs. These mandated cost drivers are expected to consume virtually all revenue growth if there is no change in current revenue sources. In its March 24, 2016, *Issuer Comment* on the Commonwealth, Moody's Investors Service, Inc., stated:

> *The authorized 2016 budget plan modestly increases spending without approving any of the taxes the governor had proposed to improve fiscal balance. The approved budget relies on nearly $1 billion of one-time measures to balance the budget, does not include a pension contribution at the full actuarially required level, and casts no light on the government's ability to reach compromise on its long-term fiscal challenges.*
>
> *Pennsylvania faces sharply higher pension contributions in the coming years, and we expect its economy to underperform due to weak demographics and poor fiscal conditions over the long term. The commonwealth's willingness to adhere to this pension contribution schedule in spite of what could be slow tax revenue growth will be a major factor in the commonwealth's credit profile over that time horizon.*

Cash Flow

The universities record their share of the State System pooled deposits and investments account at cost; that is, without regard to the fair value of the underlying investments. The associated markup or markdown for the fair value, and annual unrealized gains or losses on investments, is recorded only at the consolidated level. In fiscal year 2015/16, the unrealized gain on the State System pooled deposits and investments account was $2.6 million, and the accumulated fair value markup at June 30, 2016, was $118.5 million. This compares to an unrealized loss on investments in fiscal year 2014/15 of $13.1 million and an accumulated fair value markup of $115.2 million at June 30, 2015.

The combination of factors such as years of stagnant appropriations, declining enrollment, low interest rates, increasing personnel costs, and high long-term debt is causing cash flow pressures for several State System universities, especially during the summer months between spring and fall tuition collections. Although cash and investments that are attributed to Restricted and Auxiliary activities must be kept separate from the cash and investments that result from E&G operations, some universities are beginning to temporarily borrow from Auxiliary funds to meet payroll requirements, even though their Auxiliary operations also are experiencing significant declines in cash balances. Cash flow weaknesses, which can seriously threaten financial viability, are affecting the smaller more than the larger State System universities, whose cash flows remain relatively strong.

- Cheyney University has been borrowing from the State System pooled deposits and investments account since August 2013. The balance owed at June 30, 2016, stands at $19 million, which, along with a line of credit of an additional $3.5 million, is projected to sustain operations through most of fiscal year 2016/17. Drawdowns are taken on an as-needed basis and paid back on an as-available basis, with an interest rate based on the five-year U.S. Treasury Bond rate plus 25 basis points. The university's E&G and Auxiliary cash both would be in deficits without the borrowed funds. To ensure the security of cash inflows that have been restricted as to purpose by the donor or grantor, separate bank and investment accounts have been established for these funds, and access to them requires the approval of the Office of the Chancellor. It is anticipated that additional lines of credit will be made available to Cheyney University until break-even status is achieved. The Office of the Chancellor is working closely with the university to manage the lines of credit.

- Over the last four years, Clarion University's E&G cash has decreased by $14.1 million, or nearly 61%, from $23.3 million at June 30, 2013, to $9.2 million at June 30, 2016. Auxiliary cash has decreased by $8.4 million, or more than 55%, from $15.2 million at June 30, 2013, to $6.8 million at June 30, 2016. In fiscal year 2015/16, E&G operating and plant expenditures exceeded revenue by $7.0 million, while Auxiliary operating and plant expenditures exceeded revenue by $7.6 million. The steep decline in cash, as well as the deficits in current year operations, can be attributed in part to Clarion's use of $11.6 million of cash for capital expenditures in fiscal year 2015/16: E&G capital expenditures included $1.6 million for academic building renovations and $1.2 million for equipment and other improvements; Auxiliary capital expenditures included $5.2 million in leasehold improvements, $2.1 million in renovations for the student services facility, and $1.5 million in equipment and other improvements. The Office of the Chancellor has begun to work with Clarion University to closely monitor its cash flows.

- Over the last four years, Mansfield University's E&G cash has decreased by $10.1 million, or more than 57%, from $17.6 million at June 30, 2013, to $7.5 million at June 30, 2016. Auxiliary cash has decreased by $2.4 million, or more than 24%, from $9.8 million at June 30, 2013, to $7.4 million at June 30, 2016. In fiscal year 2015/16, E&G operating and plant expenditures exceeded revenue by $3.9 million, while Auxiliary operating and plant expenditures exceeded revenue by $1.9 million. In response, the university has reduced staff and engaged in other cost-cutting measures. The university also is instituting a per-credit tuition pilot in fiscal year 2016/17, which could help to stabilize tuition revenue despite an anticipated decline in enrollment. The Office of the Chancellor has been working with Mansfield University to closely monitor its cash flows.

- A few of the remaining universities have experienced sharp declines in E&G and/or Auxiliary cash, and although these universities have not reached critical cash levels, a continual erosion of revenue could soon cause cash flow concerns for some. The other universities have relatively strong cash balances, with several universities close to or exceeding $100 million at June 30, 2016, and West Chester's unrestricted cash balance alone close to $220 million. Overall, university E&G cash increased by $8.2 million, for a cash balance of $659.0 million at June 30, 2016, while Auxiliary cash increased by $25.6 million, for a cash balance of $336.6 million at June 30, 2016. The Office of the Chancellor is monitoring universities whose cash balance, revenue, expenditure, and enrollment trends may be an indication of future cash flow weaknesses.

Privatized Housing Acquisitions

In order to decrease operational expenses and lower the cost of debt service, several universities are purchasing the student residence halls that were constructed by their affiliated organizations by issuing tax-exempt bonds through State System bond financing and paying off affiliates' debt. Since the transactions are between related parties, GAAP requires that the universities record the assets (the buildings) at the depreciated value that was recorded on the affiliates' books at the time of acquisition by the universities. Consequently, the debt being assumed by the universities significantly exceeds the value of the asset recorded, because not only did the funds that were originally borrowed by the affiliates include noncapitalized items such as furnishings and debt service fees, but also because the annual depreciation on the housing recorded by the affiliates exceeded the annual payments that were made to reduce debt principal.

In fiscal year 2015/16, California University acquired all six of the student residence halls on campus property that had been constructed by their affiliate, Student Association, Incorporated. The book value of the housing at the time of acquisition was $55.7 million, but the debt assumed was $71.3 million, resulting in a **loss on acquisition of $15.6 million**. Despite the negative effect on its balance sheet, over the 25-year debt term the university expects to reduce debt service payments by about $34 million and avoid an estimated $18 million in operating costs such as ground lease payments, management fees, insurance, and payments in lieu of taxes.

In fiscal year 2016/17, Edinboro, Lock Haven, and Mansfield Universities are undertaking similar acquisitions of housing built by their affiliated organizations, and similar results are expected.

Revenue

In fiscal year 2016/17, the State System will receive $444.2 million in **General Fund appropriations**, an increase of $10.8 million, or 2.5%, over fiscal year 2015/16. This compares to a 5% increase received in 2015/16 over the prior fiscal year. Even with the consecutive increases in Commonwealth support, the State System will receive about $40 million less from the Commonwealth in fiscal year 2016/17 than it did in 2007/08, just before the onset of the recession that severely weakened both the state and national economies and led to several years of funding cuts to the State System.

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 $16.0 million from this revenue stream in fiscal year 2016/17, a 4.6% increase from the $15.3 million received in fiscal year 2015/16. The annual amount received is an estimate and may be adjusted based upon the health of the real estate market.

The 14 State System universities have eliminated nearly $300 million in expenditures from their combined operating budgets over the last decade in order to balance their budgets and to help hold down student costs. This, combined with the Commonwealth's boosted funding to the State System by about $31.5 million over the last two years, after seven straight years of flat or reduced general fund appropriations, has enabled the Board to approve the **smallest percentage tuition increase in more than a decade**. The $178 academic year increase approved by the Board for the 2016/17 academic year will set the base tuition rate for most full-time Pennsylvania residents—who comprise about 90 percent of all State System students—at $3,619 per semester, or $7,238 for the full year. Even with this modest increase, the State System universities will remain the lowest-cost option among all four-year colleges and universities in the state.

Nonresident, undergraduate tuition also will increase by 2.5% and will range from $10,858 to $18,096 for the 2016/17 academic year. The technology fee will be $448 for full-time resident students, and $682 for full-time nonresidents. The typical resident, graduate tuition rate will be $483 per credit, an increase of $13. The nonresident, graduate tuition rate will increase by $20 per credit, to $725.

The tuition rate increase, coupled with the increase in state appropriations, will provide almost all of the additional funds the universities need to balance their budgets. Significant cost increases are expected this year in several areas, including health care and pension contributions, over which the universities essentially have no control, as well as potential increases in salaries as a result of new collective bargaining agreements. As the number of high school graduates in the state continues to drop, most of the universities are expecting their enrollments to decline slightly, resulting in reduced revenue.

Enrollment

With an undergraduate population comprising approximately 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. Following is the projected number of Pennsylvania **high school graduates** based on estimates from the Pennsylvania Department of Education.

Projected Pennsylvania High School Graduates

Fiscal Year	Number of Graduates	% Increase (Decrease)
2015/16	124,737	0.4%
2016/17	123,878	(0.7%)
2017/18	124,636	0.6%
2018/19	124,394	(0.2%)
2019/20	121,683	(2.2%)
2020/21	122,923	1.0%
2021/22	123,582	0.5%
2022/23	121,918	(1.3%)
2023/24	123,769	1.5%

Pension Costs

In June 2016, the Pennsylvania Senate rejected a pension reform bill passed by the Pennsylvania House of Representatives that would have reduced pension benefits for future public school employees and most future state workers. The bill provided for a "stacked" plan, which required that employees change from a defined benefit plan to a defined contribution plan once their salaries exceeded $50,000, and would have increased the new employees' pension contributions to 7.5% of salary. The Senate favors a "side-by-side" plan that would be part defined benefit plan and part defined contribution plan for an employee's entire salary. Both legislative chambers have pledged to work together to come up with a compromise plan for pension reform. As of the date of these statements, there has been no consensus on pension reform and no new pension legislation enacted.

SERS

- In fiscal year 2015/16, SERS continued its increases in employer pension contribution rates. The most predominant employer-paid SERS rates for State System employees rose nearly 25% in 2015/16, after increases of 32% in 2014/15 and more than 44% in 2013/14. The rates have increased by an additional 20.5% in 2016/17, bringing the **contribution rate to 29.95%** of employees' eligible salaries. According to SERS, the rate is expected to grow to 33.3% of employees' eligible salaries in fiscal year 2017/18.

- As of December 31, 2015, the SERS **net pension liability** was $18.2 billion, compared to $14.9 billion and $13.7 billion at December 31, 2014 and 2013, respectively.

- SERS **funded ratio**, which is the actuarial value of assets compared to the actuarial accrued liability, was approximately 58.0% at December 31, 2015, compared to 59.4% and 59.2% at December 31, 2014 and 2013, respectively. For comparison, the funded ratio at December 31, 2003, was 104.9%, while SERS projects the funded ratio at December 31, 2026, to be only 69.5%.

- In 2015, more than 6,700 **new retirees** were added to the annuity payroll, with an average annual benefit of approximately $26,100; however, just 4,303 retirees, who had average annual benefits of about $14,600, were removed from the rolls. The rolls have increased by 22,629 members, or 22.2%, since 2006.

- In 2015, SERS assets produced **investment returns** of 0.4%, down from 6.4% in 2014, and far short of the 7.5% assumed long-term rate of return.

- At December 31, 2015, State System employees represented 4.69% of active SERS members.

PSERS

- In fiscal year 2015/16, PSERS also continued its increases in employer pension contribution rates. The employer-paid PSERS rates for State System employees rose nearly 21% in 2015/16, after increases of more than 26% in 2014/15 and more than 37% in 2013/14. The rates have increased by an additional 16.8% in 2016/17, bringing the **contribution rate to 15.015%** of employees' eligible salaries. This rate comprises a 14.6% rate for pension costs and 0.415% for premium assistance payments, a health care benefit given to retirees who meet certain eligibility requirements. This rate is estimated to increase an additional 6.7% in fiscal year 2017/18.

- As of June 30, 2015, the PSERS **net pension liability** was $43.3 billion, compared to $39.6 billion at June 30, 2014.

- PSERS plan **fiduciary net position** as a percentage of the total pension liability was approximately 54.4% at June 30, 2015, compared to 57.2% at June 30, 2014.

- At June 30, 2015, State System employees represented less than 0.2% of reported member salaries covered under PSERS.

ARP
The contribution rate for the ARP, a defined contribution pension plan, remains unchanged at 9.29% of employees' eligible salaries. There is no employer pension liability associated with the ARP.

Compensation Costs
All collective bargaining agreements have expired.

The Commonwealth has reached a tentative three-year labor agreement with the American Federation of State, County and Municipal Employees (**AFSCME**), which applies to State System AFSCME employees. The agreement provides general pay increases of 2.75% on October 1, 2016; 2% on July 2, 2017; and 2.5% on July 1, 2018; with longevity increases in January 2018 and 2019. In addition, the agreement increases employee contributions to the Pennsylvania Employee Benefit Trust Fund (PEBTF), which administers the health care plan for Commonwealth employees, including AFSCME employees. In conjunction with the collective bargaining process, the PEBTF approved changes to the health plan design for active and retired employees that introduce deductibles for certain in-network services and increase copays for office and emergency room visits and prescription drugs. The Commonwealth projects that these changes will help to ensure the continued financial stability of the PEBTF fund and bring the Commonwealth's benefits into closer alignment with those offered by other public and private sector employers. It is estimated that the net amount of these contract changes will cost the State System **$54.3 million** in additional salary and benefits costs through June 30, 2020.

The Association of Pennsylvania State College and University Faculties (**APSCUF**), which represents all faculty and coaches, has been working under the terms of a contract that expired June 30, 2015. In September 2016, after more than a year of negotiations with the State System, 93% of the 82% of faculty members, and 94% of the 97% of coaches, who submitted a ballot voted to authorize union leaders to call a **strike** if and when it is considered necessary. Although there has never been a strike by State System faculty or coaches, APSCUF has previously held strike authorization votes in 1999, 2003, 2007, and 2012. The short- or long-term financial impact of a strike on the universities and their students cannot be estimated but could be severely detrimental. As of the date of these financial statements, negotiations are continuing.

Negotiations continue but remain unresolved with the State College and University Professional Association (**SCUPA**), the Security Police and Fire Professionals of America (**SPFPA**), and the Office and Professional Employees International Union (**OPEIU**); however, these bargaining units are continuing to work under the terms of their most recent contracts.

Effective January 2016, the State System implemented plan design changes to the health care program for **nonrepresented employees** and employees of SPFPA and OPEIU. The changes increase employee contributions for health care through new provisions for deductibles and coinsurance and higher copays. These design changes will reduce health care costs by an estimated $3.5 million in fiscal year 2016/17.

In addition, nonrepresented employees and employees of SPFPA, OPEIU, and SCUPA hired on or after January 16, 2016, will be ineligible to participate in the State System's retiree health care plan upon their retirement. The estimated savings have not yet been calculated, but this change is expected to help ensure that a State System university education will remain affordable for future students and their families.

Performance Funding
Calls for increased accountability among colleges and universities have come from various sources across the nation. The State System has more than 15 years 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" over **$455 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 E&G budget. The Board allocated **$39.06 million** in performance funding for fiscal year 2016/17, an increase of $0.6 million over fiscal year 2015/16.

Pricing Flexibility Pilot Program

The State System's founding legislation and Board policies provide the framework under 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 27 pricing pilots, and 20 of the pilots have been implemented, while five are scheduled to be implemented in fall 2016.

The pricing pilots vary among the universities, and include differential pricing for high cost/high demand programs or courses, elimination of block tuition for 12–18 credits, reduced tuition for military, reduced tuition for off-campus sites, and/or variable out-of-state student pricing. The intent of the pricing pilots is to increase enrollment, graduation, and revenue, as well as to generate more funding for need-based financial aid. In addition, this new practice is part of the Board's efforts to strike a better balance between State System coordination and more local decision-making.

Cheyney University of Pennsylvania

Cheyney University ended fiscal year 2015/16 with a $4.3 million loss in E&G activity and a $1.4 million loss in Auxiliary activity, for a total unrestricted loss of $5.7 million, bringing the university's unrestricted net position deficit to $17.6 million at June 30, 2016 (excluding unfunded pension, postretirement, and compensated absences liabilities). This follows a $5.5 million loss in unrestricted funds in fiscal year 2014/15 and a $4.2 million loss in fiscal year 2013/14. Gross tuition and fees dropped $2.3 million, from $9.8 million in fiscal year 2014/15 to $7.5 million in fiscal year 2015/16. Auxiliary revenue dropped $2.1 million, from $7.4 million in fiscal year 2014/15 to $5.3 million in fiscal year 2015/16.

The university's preliminary projections reflect a $10.4 million loss in E&G activity and a $3.8 million loss in Auxiliary activity in fiscal year 2016/17, which would bring the university's unrestricted net position to a projected deficit of $31.8 million (excluding unfunded pension, postretirement, and compensated absences liabilities) at June 30, 2017. Cheyney's fall 2016 enrollment was 739 students, approximately the same as its fall 2015 enrollment, but a 31% decrease from the 1,022 students enrolled in fall 2014.

As of June 30, 2016, the university has borrowed $19 million from the State System pooled investment account; without this line of credit, the university's unrestricted E&G and Auxiliary cash balances would be a negative $15.4 million. To ensure the security of cash inflows that have been restricted as to purpose by the donor or grantor, separate bank and investment accounts have been established for these funds, and access to them requires the approval of the Office of the Chancellor.

As detailed in the disclosures attached to these financial statements under Note (13), *Contingencies and Commitments*, Cheyney University is awaiting a response from the U.S. Department of Education (ED) to the university's voluntary self-reporting to the ED in August 2015 that $29.6 million of federal student financial aid was improperly administered and delivered in fiscal years 2011/12, 2012/13, and 2013/14, covering almost 4,400 student records. The State System has been engaged with the ED since reporting these findings. In addition, in January 2016, the U.S. Department of Justice (DOJ) notified the State System that it was investigating the application and use of federal student financial aid by Cheyney University and the oversight of the university by the State System. The DOJ requested that the university and State System preserve and produce certain documents. The State System has fully complied with DOJ's request. No action has been taken at this point by the DOJ, and the possible resulting outcomes from the investigation are uncertain until communication is received from the DOJ.

The third party hired by the State System to administer the university's federal financial aid programs for 2014/15, 2015/16, and 2016/17 has successfully implemented processes to ensure that the university's administrative policies and procedures, information systems, and data are properly aligned and integrated to support the award and distribution of financial aid. The State System believes that these efforts will ensure that Cheyney University's federal student aid programs are administered in compliance with federal regulations.

One consequence of the university's past deficiencies in administering federal student aid is that in September 2015 the ED placed the university on Heightened Cash Monitoring 2 (HCM2) status, meaning that the university does not receive federal student financial aid funds in advance, but must use its own cash to grant federal financial aid to its students and then request reimbursement from the ED. After demonstrating compliance with HCM2 requirements, the university received its spring 2016 federal student aid funds in July, but has not yet received its fall 2016 federal student aid funds. The delay in receipt of funds is causing further pressure on the university's severe cash shortage.

As further detailed in Note (13), Cheyney University was placed on probation by the Middle States Commission on Higher Education (Middle States) in November 2015, jeopardizing its accreditation. The university has been given two years to address the deficiencies noted by Middle States. In September 2016, the university submitted the first required monitoring report, documenting its plan for remediation. As part of this plan, the university has contracted with a third party to administer its information technology systems and has begun the outsourcing of its administrative functions, including finance, human resources, and facilities, to nearby West Chester University. The State System, through the Office of the Chancellor, continues to provide oversight to Cheyney's leadership in an attempt to stabilize its financial condition and implement a comprehensive plan that includes timely and accurate financial aid processing, increasing student enrollment, restructuring course offerings, revitalizing its academic program array, and right-sizing personnel and facilities.

Moody's Rating and Outlook

In August 2016, Moody's Investors Service, Inc. (Moody's), reaffirmed the State System's **bond rating of Aa3**, but revised the outlook from *negative* to *stable*, "reflecting demonstrated ability to adjust to ongoing enrollment pressures combined with a more predictable near term state funding environment with the budget enactments from the Commonwealth of Pennsylvania." In its August 10, 2016, *Credit Opinion*, Moody's stated:

> *PASSHE's Aa3 rating reflects its large scale as a public university system of 14 campuses located throughout the Commonwealth of Pennsylvania, strong liquidity and very good system management and governance addressing system-wide revenue and expense pressures, and significant debt principal repayments scheduled over the next two years. Also incorporated is our expectation of stabilizing enrollment, continued net tuition revenue growth, and good cash flow. Offsetting factors include high leverage including significant pension and other post-retirement benefit liabilities, and rising expenses in part driven by these employee benefits. Also, some member universities have significant financial and enrollment challenges which will likely be addressed over a multi-year period.*

Moody's details as State System **challenges** high leverage, with $2.4 billion of total debt, including foundation student housing; limitations to cost management efforts because of the high percentage of staff, including faculty, that are subject to collective bargaining agreements; significant pension and OPEB liabilities with required contributions; pressured operations with thinning cash flow; and management of enrollment and financial challenges at certain campuses.

Moody's details as State System **strengths** its substantial balance sheet reserves; its significant scale as one of the nation's largest higher education systems; effective System governance and management, including strong fiscal oversight and debt management; positive cash flow; and modest near-term debt plans with rapidly amortizing debt.

Moody's predicts that a ratings upgrade could result from consistently stronger operating performance and cash flow generation, significantly strengthened and growing enrollment across the State System, and a restructuring of postretirement benefits to significantly reduce the OPEB liability and pension costs. Conversely, a ratings downgrade could result from a decrease in unrestricted liquidity, the inability to manage expense growth to accommodate rising employee benefit costs, continued enrollment declines despite stabilization of college-age population statewide, prolonged inability to address challenges at struggling campuses, and a weakening of the Commonwealth's credit profile.

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, 2016	June 30, 2015
Current Assets		
Cash and cash equivalents	$ 20,519	$ 20,314
Short-term investments	649,417	534,596
Accounts receivable, students, net of allowance for doubtful accounts of $30,049 in 2016 and $30,578 in 2015	42,765	44,397
Accounts receivable, other	30,827	24,742
Governmental grants and contracts receivable	16,986	23,121
Inventories	2,958	3,569
Prepaid expenses	14,031	11,723
Current portion of loans receivable, net	8,638	8,681
Due from component units	23,015	26,393
Other current assets	2,646	2,366
Total Current Assets	811,802	699,902
Noncurrent Assets		
Restricted cash and cash equivalents	25	131
Endowment investments	29,596	30,270
Other long-term investments	676,630	748,621
Loans receivable, net	32,474	33,505
Due from component units	9,160	10,324
Capital Assets:		
Land	32,360	32,360
Buildings, including improvements	2,213,463	2,056,185
Improvements other than buildings	285,136	274,779
Equipment and furnishings	470,347	454,128
Library books	81,314	81,940
Construction in progress	80,012	99,144
	3,162,632	2,998,536
Less accumulated depreciation	(1,509,343)	(1,409,352)
Capital assets, net	1,653,289	1,589,184
Other noncurrent assets	1,873	1,497
Total Noncurrent Assets	2,403,047	2,413,532
Total Assets	3,214,849	3,113,434
Deferred Outflows of Resources	191,221	73,556
Total Assets and Deferred Outflows of Resources	$ 3,406,070	$ 3,186,990

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, 2016	June 30, 2015
Current Liabilities		
Accounts payable and accrued expenses	$ 162,520	$ 154,790
Unearned revenue	50,448	50,309
Deposits	40,691	45,974
Current portion of workers' compensation liability	4,419	4,686
Current portion of compensated absences liability	9,990	10,670
Current portion of capitalized lease obligations	3,476	3,364
Current portion of bonds payable	62,885	55,890
Due to component units	10,693	10,562
Other current liabilities	77,241	39,235
Total Current Liabilities	422,363	375,480
Noncurrent Liabilities		
Unearned revenue	4,615	4,173
Workers' compensation liability, net of current portion	17,672	17,864
Compensated absences liability, net of current portion	105,433	103,970
Capitalized lease obligations, net of current portion	45,170	48,228
Bonds payable, net of current portion	779,705	744,565
Postretirement benefits liability	1,106,643	1,058,749
Net pension liability	938,637	798,744
Other noncurrent liabilities	77,652	78,409
Total Noncurrent Liabilities	3,075,527	2,854,702
Total Liabilities	3,497,890	3,230,182
Deferred Inflows of Resources	30,162	15,311
Net Position		
Net investment in capital assets	709,271	700,280
Restricted for:		
Nonexpendable:		
Scholarships and fellowships	32,505	29,696
Student loans	4,538	4,034
Other	3,961	7,563
Expendable:		
Scholarships and fellowships	21,074	16,537
Research	248	1,330
Capital projects	37,406	20,270
Other	14,723	18,643
Unrestricted	(945,708)	(856,856)
Total Net Position	(121,982)	(58,503)
Total Liabilities, Deferred Inflows of Resources, and Net Position	$ 3,406,070	$ 3,186,990

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, 2016 and 2015
(dollars in thousands)

	2016		2015	
Operating Revenues				
Tuition and fees	$ 1,065,416		$ 1,050,135	
Less discounts and allowances	(226,381)		(233,562)	
Net tuition and fees		$ 839,035		$ 816,573
Governmental grants and contracts:				
Federal		37,519		34,393
State		104,650		104,967
Local		4,595		4,094
Nongovernmental grants and contracts		8,758		7,208
Sales and services		37,660		41,885
Auxiliary enterprises, net of discounts of $1,782 in 2016 and $1,749 in 2015		323,358		324,007
Other revenues, net		8,446		10,736
Total Operating Revenues		1,364,021		1,343,863
Operating Expenses				
Instruction		749,290		739,633
Research		6,304		5,757
Public service		39,381		37,504
Academic support		184,037		179,055
Student services		184,675		180,958
Institutional support		257,261		248,507
Operations and maintenance of plant		159,904		153,508
Depreciation		121,683		119,652
Student aid		79,136		72,948
Auxiliary enterprises		253,786		255,742
Total Operating Expenses		2,035,457		1,993,264
Operating Loss		(671,436)		(649,401)
Nonoperating Revenues (Expenses)				
State appropriations, general and restricted		433,389		412,751
Commonwealth on-behalf pension contributions		7,952		6,592
Pell grants		138,575		145,658
Investment income, net of related investment expense of $354 in 2016 and $223 in 2015		23,979		31,010
Unrealized gain (loss) on investments		2,551		(13,055)
Gifts for other than capital purposes		28,544		16,557
Interest expense on capital asset-related debt		(33,920)		(36,577)
Loss on disposal/acquisition of assets		(20,490)		(9,622)
Other nonoperating revenue		4,018		1,554
Net Nonoperating Revenues		584,598		554,868
Loss before other revenues		(86,838)		(94,533)
State appropriations, capital		15,714		13,610
Capital gifts and grants		7,620		4,145
Additions to permanent endowments		25		105
Decrease in Net Position		(63,479)		(76,673)
Net position—beginning of year		(58,503)		739,048
Restatement for July 1, 2014, pension liability and related expense				(720,878)
Net position—beginning of year, restated				18,170
Net position—end of year		$ (121,982)		$ (58,503)

See accompanying notes to financial statements.

Pennsylvania's State System of Higher Education

Statement of Cash Flows
For the Years Ended June 30, 2016 and 2015
(dollars in thousands)

	2016	2015
Cash Flows from Operating Activities		
Tuition and fees	$ 840,059	$ 816,148
Grants and contracts	160,543	151,234
Payments to suppliers for goods and services	(442,726)	(422,825)
Payments to employees	(1,304,770)	(1,288,967)
Loans issued to students	(5,374)	(7,763)
Loans collected from students	6,442	7,034
Student aid	(79,503)	(74,020)
Auxiliary enterprise charges	324,031	322,451
Sales and services	37,044	41,694
Other receipts (payments)	42,606	4,709
Net cash used in operating activities	(421,648)	(450,305)
Cash Flows from Noncapital Financing Activities		
State appropriations	433,389	412,751
Gifts and nonoperating grants for other than capital purposes	162,524	162,424
PLUS, Stafford, and other loans receipts (non-Perkins)	1,144,667	893,464
PLUS, Stafford, and other loans disbursements (non-Perkins)	(1,144,646)	(893,505)
Agency transactions, net	(3,598)	1,843
Other	4,018	1,555
Net cash provided by noncapital financing activities	596,354	578,532
Cash Flows from Capital Financing Activities		
Proceeds from capital debt and leases	86,798	106,909
Capital appropriations	15,714	13,607
Capital grants and gifts received	4,184	3,369
Proceeds from sales of capital assets	101	194
Purchases of capital assets	(115,657)	(96,657)
Principal paid on capital debt and leases	(110,963)	(157,849)
Interest paid on capital debt and leases	(43,450)	(45,429)
Net cash used in capital financing activities	(163,273)	(175,856)
Cash Flows from Investing Activities		
Proceeds from sales and maturities of investments	20,624,557	17,772,937
Interest on investments	23,672	30,866
Purchase of investments	(20,659,563)	(17,784,282)
Net cash provided by investing activities	(11,334)	19,521
Net Increase in Cash and Cash Equivalents	99	(28,108)
Cash and cash equivalents—beginning of year	20,445	48,553
Cash and cash equivalents—end of year	$ 20,544	$ 20,445

See accompanying notes to financial statements.

Pennsylvania's State System of Higher Education

Statement of Cash Flows
For the Years Ended June 30, 2016 and 2015
(dollars in thousands)

	2016	2015
Reconciliation of Operating Loss to Net Cash Used in Operating Activities		
Operating loss	$ (671,436)	$ (649,401)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation expense	121,683	119,652
Expenses paid by Commonwealth or donor	7,062	6,032
Effect of changes in operating assets and liabilities:		
Receivables, net	7,614	898
Inventories	611	(98)
Other assets	(4,180)	(12,746)
Accounts payable	(5,119)	135
Unearned revenue	602	(1,332)
Student deposits	(1,148)	(173)
Compensated absences	783	(82)
Loans to students and employees	1,067	(728)
Other liabilities	120,813	87,538
Net cash used in operating activities	$ (421,648)	$ (450,305)
Noncash Activities		
Capital assets included in payables	$ 14,602	$ 5,902
Capital assets acquired through capital leases or assumption of debt	$ 56,131	$ 1,161
Capital assets acquired by gift or appropriation	$ 4,391	$ 1,190
Debt assumed in acquisition of capital assets	$ 71,299	$ -
Like-kind exchanges	$ 4	$ 15
Commonwealth on-behalf contributions to PSERS	$ 7,952	$ 6,592

See accompanying notes to financial statements.

Pennsylvania's State System of Higher Education

Component Units Statement of Financial Position

(dollars in thousands)

	June 30, 2016	*(Restated)* June 30, 2015
Assets		
Cash and cash equivalents	$ 147,696	$ 141,796
Accounts receivable	7,014	6,926
Contributions/pledges receivable	18,540	16,568
Due from universities	12,128	10,711
Prepaid expenses	2,377	3,162
Inventories	7,340	8,701
Short-term investments	71,077	70,229
Investments	398,311	464,466
Capital assets:		
Land	32,471	31,724
Buildings	1,308,775	1,282,094
Building improvements	18,538	19,313
Improvements other than buildings	9,023	10,370
Equipment and furnishings	89,355	93,383
Construction in progress	50,587	99,614
	1,508,749	1,536,498
Less accumulated depreciation	(276,262)	(287,022)
Capital assets, net	1,232,487	1,249,476
Other assets	114,891	131,723
Total Assets	$ 2,011,861	$ 2,103,758
Liabilities		
Accounts payable and accrued expenses	$ 32,539	$ 31,117
Deferred revenue	10,682	10,221
Interest payable	11,091	10,402
Annuity liabilities	7,012	7,538
Due to universities	31,899	36,417
Deposits payable	22,409	22,140
Interest rate swap agreements	84,662	60,596
Capitalized leases	28,428	29,151
Bonds payable	1,131,757	1,232,289
Notes payable	307,299	296,239
Other liabilities	10,819	20,046
Total Liabilities	1,678,597	1,756,156
Net Assets		
Unrestricted	(13,833)	9,873
Temporarily restricted	97,878	95,560
Permanently restricted	249,219	242,169
Total Net Assets	333,264	347,602
Total Liabilities and Net Assets	$ 2,011,861	$ 2,103,758

See accompanying notes to financial statements.

Pennsylvania's State System of Higher Education

Component Units Statement of Activities
For the Years Ended June 30, 2016 and 2015
(dollars in thousands)

	2016	(Restated) 2015
Revenues and Gains		
Contributions	$ 40,443	$ 38,537
Sales and services	47,255	47,792
Student fees	33,853	34,351
Grants and contracts	11,162	11,591
Rental income	171,073	169,980
Investment income, gains, and losses	9,365	17,115
Other revenues and gains	37,430	16,092
Total Revenues and Gains	350,581	335,458
Expenses and Losses		
Program services:		
Scholarships and grants	16,456	14,106
Student activities and programs	31,020	31,830
University stores	29,141	30,687
Housing	157,866	162,946
Other university support	21,533	16,313
Other programs	19,986	16,448
Management and general	34,626	28,667
Fundraising	10,821	9,908
Other expenses and losses	43,470	16,796
Total Expenses and Losses	364,919	327,701
Change in Net Assets	(14,338)	7,757
Net assets—beginning of year	347,602	357,765
Restatement for July 1, 2015, change in reporting entity	-	(17,920)
Net assets—beginning of year, restated	347,602	339,845
Net assets—end of year	$ 333,264	$ 347,602

See accompanying notes to financial statements.

NOTES TO FINANCIAL STATEMENTS

Years Ended June 30, 2016 and 2015

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

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.

During fiscal year 2015/16, Mansfield University of Pennsylvania disaffiliated the Mansfield University Foundation, Inc., a former component unit. The combined component unit financial statements for fiscal year 2014/15 have been restated accordingly and result in a reduction of $18,669,000 of component unit assets, and a reduction of $357,000 of component unit liabilities, which, when combined with the fiscal year 2014/15 respective change in net assets of $392,000, result in a restatement of beginning net assets of $17,920,000.

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 (GAAP), 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.

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). *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).

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

The State System is required to report the following as Deferred Outflows of Resources or Deferred Inflows of Resources.

- Deferred gain or loss on bond refundings, which results when the carrying value of a refunded bond is greater or 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.
- For defined benefit pension plans: the difference between expected (actuarial) and actual experience, changes in actuarial assumptions, net difference between projected (actuarial) and actual earnings on pension plan investments, changes in the State System's proportion of expenses and liabilities to the pension as a whole, differences between the State System's pension contributions and its proportionate share of contributions, and State System pension contributions subsequent to the pension valuation measurement date.

Net Position
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 on a composite basis in the year of purchase. 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, 2016 and 2015.

Unearned 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.

Compensated Absences

The estimated cost of future payouts of annual leave and sick leave that employees have earned for services rendered, and which the employees may be entitled to receive upon termination or retirement, is recorded as a liability.

Pension Plans

Employees of the State System enroll in one of three available retirement plans immediately upon employment. The Commonwealth of Pennsylvania State Employees' Retirement System (SERS) and the Public School Employees' Retirement System

(PSERS) are governmental cost-sharing multiple-employer defined benefit plans. The Alternative Retirement Plan (ARP) is a defined contribution plan administered by the State System.

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 *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 the previously reported net position or changes therein.

New Accounting Standards
The State System has implemented GASB Statement No. 72, *Fair Value Measurement and Application*. This statement addresses accounting and financial reporting issues related to fair value measurements. In accordance with Statement No. 72, the State System has classified its investments as *Level 1*, *Level 2*, or *Level 3*, to indicate the degree of certainty around the assets' underlying values (note 2).

In June 2015, GASB issued Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. These statements establish new accounting and financial reporting requirements for governments whose employees are provided with OPEB (other postemployment benefits), as well as for certain nonemployer governments that have a legal obligation to provide financial support for OPEB provided to the employees of other entities. These statements will require the State System to record its postretirement health care liability in its entirety: in its most recent actuarial valuation dated July 1, 2014, the State System's accrued postretirement health care liability, as calculated by the actuaries, was $1,194,849,000, but under current GASB requirements, the amount recorded on the balance sheet as a liability at June 30, 2016, was $1,106,643,000. The State System expects that the amount recorded on the balance sheet as a postretirement health care liability will increase when Statement No. 75 is implemented, but the amount cannot be calculated until a new actuarial valuation is performed under the new standards. Furthermore, Statement No. 75 will require that the State System record the liability for its employees who participate in the Commonwealth's Retired Employees Health Plan (REHP). Under current GASB standards, the State System does not report a share of the REHP's unfunded liability since the REHP is a multiple-employer cost-sharing plan administered by the Pennsylvania Employee Benefits Trust Fund (PEBTF). The amount that the State System will have to record as its share of the liability when Statement No. 75 becomes effective is unknown; however, the amount is expected to have a material negative effect on the State System's balance sheet. The provisions in Statement No. 74 are effective for fiscal years beginning after June 15, 2016; the provisions in Statement No. 75 are effective for fiscal years beginning after June 15, 2017.

In December 2015, GASB issued Statement No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans.* Statement No. 78 excludes certain pensions from the provisions of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The State System has determined that Statement No. 78 does not apply to its pension plans and has no effect on its financial statements.

In December 2015, GASB issued Statement No. 79, *Certain External Investment Pools and Pool Participants.* Statement No. 79 applies to arrangements that commingle the moneys of more than one legally separate entity and invest on the participants' behalf in an investment portfolio. The State System has determined that Statement No. 79 does not apply to its investments and has no effect on its financial statements.

In June 2016, GASB issued Statement No. 80, *Blending Requirements for Certain Component Units—an amendment of GASB Statement No. 14*. Statement No. 80 requires blending of a component unit incorporated as a not-for-profit corporation in which the primary government (university) is the sole corporate member. The State System has determined that Statement No. 80 does not apply to its component units and has no effect on its financial statements.

In March 2016, GASB issued Statement No. 81, *Irrevocable Split-Interest Agreements.* Statement No. 81 provides recognition and measurement guidance for gifts received from donors who have transferred the gifts to an intermediary to hold and administer for the government (university) and at least one other beneficiary. An example of a split-interest agreement is a charitable remainder trust. The provisions in Statement No. 81 are effective for reporting periods beginning after December 15, 2016. The State System has determined that Statement No. 81 applies to a small number of certain local university investments and will have an immaterial effect on its financial statements.

In March 2016, GASB issued Statement No. 82, *Pension Issues—an amendment of GASB Statements No. 67, No. 68, and No. 73.* Statement No. 82 addresses technical issues related to previous GASB guidance on pensions. The State System has determined that Statement No. 82 will have no effect on its financial statements.

(2) DEPOSITS AND INVESTMENTS

On June 30, 2016 and 2015, the carrying amount of the State System's demand and time deposits and certificates of deposit for all funds was $20,558,000 and $20,458,000, respectively, compared to bank balances of $20,280,000 and $19,970,000, respectively. The difference is caused primarily by items in transit. Of the bank balances, $4,214,000 and $3,200,000, 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; $608,000 and $660,000, respectively, were uninsured and uncollateralized; and $15,458,000 and $16,110,000, 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.

Board of Governors' 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 of Governors' 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 U.S. 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.

Fair Value Hierarchy: GASB Statement No. 72, *Fair Value Measurement and Application*, requires that investments be classified according to a "fair value hierarchy." With respect to Statement No. 72's fair value hierarchy, GASB defines "inputs" as "the assumptions that market participants would use when pricing an asset or liability, including assumptions about risk." Statement No. 72 further categorizes inputs as *observable* or *unobservable*: *Observable inputs* are "inputs that are developed using market data, such as publicly available information about actual events or transactions, and which reflect the assumptions that market participants would use when pricing an asset or liability"; *Unobservable inputs* are "inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing an asset or liability."

Statement No. 72's fair value hierarchy categorizes the inputs to valuation techniques used to measure fair value into three "levels":

Level 1: Investments whose values are based on unadjusted quoted prices for identical assets or liabilities in an active market, such as stocks listed in the S&P 500 or NASDAQ. If an up-to-date price of the investment can be found on a major exchange, it is a Level 1 investment.

Level 2: Investments whose values are based on their quoted prices in inactive markets or whose values are based on models, and the inputs to those models are observable either directly or indirectly for substantially the full term of the asset or liability.

Level 3: Investments that trade infrequently, and as a result do not have many reliable market prices. Valuations of Level 3 investments typically are based on management assumptions or expectations. For example, a private equity investment or complex derivative would likely be a Level 3 investment.

In addition, the fair value of certain investments that do not have a readily determinable fair value is classified as *NAV*, meaning Net Asset Value per share, when the fair value is calculated in a manner consistent with the Financial Accounting Standards Board's measurement principles for investment companies.

Debt and equity securities classified in Level 1 of the fair value hierarchy are valued using prices quoted in active markets for those securities. Debt and equity securities classified in Level 2 of the fair value hierarchy are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices. Securities classified in Level 3 of the fair value hierarchy lack an independent pricing source and so are valued using an internal fair value as provided by the investment manager.

Commonfund investments, held locally by some of the universities, are valued based upon the unit values (NAV) of the funds held by the universities at year end. Unit values are based upon the underlying assets of the funds derived from inputs principally from or corroborated by observable market data, by correlation, or other means. Redemption restrictions for the Commonfund vary, depending upon the type of fund in which the universities have invested, and are restricted to withdrawals only on a weekly basis or the last business day of the month. All withdrawals require five days' notice.

State System Pooled Deposits and Investments
The carrying values (fair values) of deposits and investments for the State System's pooled funds in M&T Bank on June 30, 2016 and 2015, follow.

State System Pooled Deposits and Investments
June 30, 2016
(in thousands)

	Fair Value Hierarchy Level	**Moody's Rating** (if applicable)	**Modified Duration** (if applicable)	**Fair Value**
Deposits				
Demand and time deposits				$28
Money market funds				5,296
Total deposits				5,324
Investments				
Commercial paper	2	P1	0.17	265,251
Government money market mutual fund	2	Aaa	0.00	79,979
U.S. government and agency obligations	2	Aaa	2.45	414,573
Asset-backed securities	2	Aaa	0.48	93,876
	2	P1	0.15	14,988
Collateralized mortgage obligations (CMOs)	2	Aaa	2.15	193,070
Corporate bonds and notes	2	Aaa	1.34	6,197
	2	Aa1	1.33	6,740
	2	Aa2	1.41	9,670
	2	Aa3	1.51	3,332
	2	A1	1.26	63,506
	2	A2	1.33	66,345
	2	A3	2.54	36,713
	2	Baa1	1.91	27,436
	2	Baa2	0.99	21,771
	2	Baa3	0.00	727
Total investments				1,304,174
Total deposits and investments				$1,309,498

State System Pooled Deposits and Investments
June 30, 2015
(in thousands)

	Fair Value Hierarchy Level	**Moody's Rating** (if applicable)	**Modified Duration** (if applicable)	**Fair Value**
Deposits				
Demand and time deposits				$114
Money market funds				7,968
Total deposits				8,082
Investments				
Commercial paper	2	Aaa	0.06	7,602
	2	P1	0.31	150,938
Government money market mutual fund	2	Aaa	0.00	62,832
U.S. government and agency obligations	2	Aaa	2.62	440,072
Asset-backed securities	2	Aaa	0.76	88,060
	2	Aa1	1.71	6,225
	2	P1	0.40	17,426
Collateralized mortgage obligations (CMOs)	2	Aaa	4.10	251,458
Corporate bonds and notes	2	Aaa	1.12	11,300
	2	Aa1	2.73	7,690
	2	Aa2	0.63	18,395
	2	Aa3	1.10	8,803
	2	A1	1.33	34,951
	2	A2	1.51	64,851
	2	A3	1.39	39,524
	2	Baa1	1.14	33,932
	2	Baa2	1.03	22,203
	2	Baa3	0.00	725
Total investments				1,266,987
Total deposits and investments				$1,275,069

Of the investments noted above at June 30, 2016 and 2015, $13,527,000 and $4,569,000, 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). Such 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.

University Local Deposits and Investments
The carrying values (fair values) of local university deposits and investments on June 30, 2016 and 2015, follow.

University Local Deposits and Investments
June 30, 2016
(in thousands)

	Fair Value Hierarchy Level	Moody's Rating (if applicable)	Modified Duration (if applicable)	Fair Value
Deposits				
Demand and time deposits				$15,220
Certificates of deposit				14
Total deposits				15,234
Investments				
U.S. government and agency obligations	2	Aaa	0.47	164
Bond mutual funds	2		4.98	1,744
	NAV		4.43	11,143
Debt securities	2	AA	1.10	25
	2	Aa1	5.25	26
	2	Aa2	2.76	31
Equity/balanced mutual funds	1			2,385
	2			3,345
	3			7,006
	NAV			23,267
Common stock	1			2,319
Total investments				51,455
Total deposits and investments				$66,689

University Local Deposits and Investments
June 30, 2015
(in thousands)

	Fair Value Hierarchy Level	Moody's Rating (if applicable)	Modified Duration (if applicable)	Fair Value
Deposits				
Demand and time deposits				$12,362
Certificates of deposit				14
Total deposits				12,376
Investments				
U.S. government and agency obligations	2	Aaa	0.55	72
Bond mutual funds	2		4.40	1,466
	NAV		4.84	4,438
Debt securities	2	AA	2.10	25
	2	Aa1	6.80	26
	2	Aa2	3.70	30
Equity/balanced mutual funds	1			1,624
	2			3,168
	3			2,369
	NAV			30,651
Common stock	1			2,618
Total investments				46,487
Total deposits and investments				$58,863

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

(in thousands)		Fair Value	
Investment	**Currency**	June 30, 2016	June 30, 2015
Deposit	British Pound	$0	$6

The universities are beneficiaries of trust funds held by others with an approximate fair value of $4,087,000 and $3,795,000 on June 30, 2016 and 2015, 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 $15,955,000 and $16,371,000 for the years ended June 30, 2016 and 2015, respectively.

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

(in thousands)	**June 30, 2016**	**June 30, 2015**
Cost:		
Buildings	$76,431	$76,416
Equipment	3,074	3,520
Total	$79,505	$79,936
Accumulated Depreciation:		
Buildings	$38,027	$33,748
Equipment	1,501	1,805
Total	$39,528	$35,553

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**
2017	$7,525	$5,697
2018	5,573	5,570
2019	4,654	5,501
2020	3,721	5,193
2021	2,843	5,059
Thereafter	56,516	37,824
Total minimum lease payments	$80,832	64,844
Amount representing interest on capital leases		16,198
Present value of net minimum capital lease payments		$48,646

Changes in the liability for capital leases in fiscal years 2016 and 2015 follow.

(in thousands)

Year	**Beginning Balance**	**Capital Lease Additions**	**Capital Lease Payments**	**Ending Balance**
2015	$53,791	$1,161	$3,360	$51,592
2016	$51,592	$431	$3,377	$48,646

(4) Pension Benefits

Employees of the State System enroll in one of three available retirement plans immediately upon employment: the Commonwealth of Pennsylvania State Employees' Retirement System (SERS), the Public School Employees' Retirement System (PSERS), or the Alternative Retirement Plan (ARP).

Following is the total of the State System's pension liabilities, deferred outflows and inflows of resources related to pensions, and the pension expense for the fiscal years ended June 30, 2016 and 2015.

(in thousands)

	SERS		PSERS		ARP		Total	
	2016	2015	2016	2015	2016	2015	2016	2015
Net pension liabilities	**$858,417**	**$728,094**	**$80,220**	**$70,650**	**$0**	**$0**	**$938,637**	**$798,744**
Deferred outflows of resources:								
Difference between expected and actual experience	$17,381	$3,953					$17,381	$3,953
Net difference between projected and actual investment earnings on pension plan investments	87,404	21,036					87,404	21,036
Changes in assumptions	25,503						25,503	
Difference between employer contributions and proportionate share of contributions			$568	$295			568	295
Changes in proportion			3,550	1,682			3,550	1,682
Contributions after the measurement date	41,639	32,028	6,012	5,213			47,651	37,241
Total deferred outflows of resources	**$171,927**	**$57,017**	**$10,130**	**$7,190**	**$0**	**$0**	**$182,057**	**$64,207**
Deferred inflows of resources:								
Difference between expected and actual experience			$331				$331	
Net difference between projected and actual investment earnings on pension plan investments			162	$5,051			162	$5,051
Difference between employer contributions and proportionate share of contributions	$2,389	$2,182					2,389	2,182
Changes in proportion	26,207	6,867					26,207	6,867
Total deferred inflows of resources	**$28,596**	**$9,049**	**$493**	**$5,051**	**$0**	**$0**	**$29,089**	**$14,100**
Pension expense	**$103,982**	**$83,545**	**$16,035**	**$6,663**	**$43,933**	**$44,619**	**$163,950**	**$134,827**
Contributions recognized by pension plans	**$69,021**	**$57,234**	**$6,012**	**$5,236**	**N/A**	**N/A**	**$75,033**	**$62,470**

The State System will recognize the $41,639,000 reported as 2016 SERS deferred outflows of resources resulting from pension contributions after the measurement date, and the $6,012,000 reported as 2016 PSERS deferred outflows of resources resulting from pension contributions after the measurement date, as reductions of the respective net pension liabilities in the year ended June 30, 2017. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows.

(in thousands)

	Amortization	
Fiscal Year Ended	**SERS**	**PSERS**
June 30, 2017	$26,357	$680
June 30, 2018	$26,357	$680
June 30, 2019	$26,357	$680
June 30, 2020	$21,746	$1,585
June 30, 2021	$875	$0

SERS

Plan Description

SERS is the administrator of a cost-sharing multiple-employer defined benefit plan established by the Commonwealth to provide pension benefits for employees of state government and certain independent agencies. SERS is a component unit of the Commonwealth and is included in the Commonwealth's financial report as a pension trust fund. Membership in SERS is mandatory for most state employees. Members and employees of the General Assembly, certain elected or appointed officials in the executive branch, department heads, and certain employees in the field of education are not required, but are given the option, to participate. 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 at www.sers.state.pa.us.

Benefits Provided

SERS provides retirement, death, and disability benefits. Article II of the Commonwealth's Constitution assigns the authority to establish and amend the benefit provision of the plan to the General Assembly. Cost of Living Adjustments (COLA) are provided ad hoc at the discretion of the General Assembly.

Employees who were hired prior to January 1, 2011, and retire at age 60 with three years of service, or with 35 years of service if under age 60, are entitled to a normal annual retirement benefit; members of the General Assembly and certain employees classified in hazardous duty positions can retire with full benefits at age 50 with at least three years of service. Act 120 of 2010 (Act 120) preserved all benefits in place for members, but mandated a number of benefit reductions for new members effective January 1, 2011. The benefit reduction included a new class of membership that accrues benefits at 2% of members' final average salary instead of the previous 2.5%. The new vesting period changed from 5 to 10 years of credited service, and the option to withdraw lump-sum accumulated deductions was eliminated. The new normal retirement age is 65 for most employees and 55 for members of the General Assembly and certain employees classified in hazardous duty positions.

According to the State Employees' Retirement Code (SERC), all obligations of SERS will be assumed by the Commonwealth should SERS terminate.

Contributions

The contribution rate for both active members and the State System depends upon when the active member was hired and what benefits class was selected. Section 5507 of the SERC (71 Pa. C.S. §5507) requires the Commonwealth and other employers whose employees are SERS members to make contributions to the fund on behalf of all active members and annuitants necessary to fund the liabilities and provide the annuity reserves required to pay benefits. The SERS funding policy, as set by the SERS Board, provides for periodic active member contributions at statutory rates. The SERS funding policy also provides for periodic employer contributions at actuarially determined rates based on SERS' funding valuation, expressed as a percentage of annual retirement covered payroll, such that the employer contributions, along with employee contributions and an actuarially determined rate of investment return, are adequate to accumulate assets to pay benefits when due. Act 120, however, imposed rate increase collars (limits on annual rate increases) on employer contributions. The collar for Commonwealth fiscal year 2014/15 was 4.5% and will remain at that rate until no longer needed.

The State System contributed at actuarially determined rates of between 17.18% and 24.86% of active members' annual covered payroll at June 30, 2016. The State System's contributions to SERS for the years ended June 30, 2016, 2015, and 2014, were $69,021,000, $57,234,000, and $43,548,000, respectively, equal to the required contractual contribution.

Contribution rates for most active members is 6.25% of gross salary. The contribution rate for other members ranges between 5% and 9.3% of salary, depending upon when the member was hired and what class of membership was elected.

Assumptions
The total SERS pension liabilities used to calculate the net pension liabilities were determined by actuarial valuations as of December 31, 2015 and 2014, using the following actuarial assumptions, applied to all periods included in the measurement.

- Entry age actuarial cost method.
- Straight-line amortization of investments over five years and amortization of assumption changes and noninvestment gains/losses over the average expected remaining service lives of all employees that are provided benefits.
- Inflation of 2.75%.
- Investment return of 7.50%, net of expenses and including inflation.
- Salary increases based on an average of 5.70%, with a range of 3.85% to 9.05%, including inflation.
- Asset valuation using fair (market) value.
- Mortality rates based on the projected RP-2000 Mortality Tables, adjusted for actual plan experience and future improvement.
- Ad hoc cost of living adjustments (COLAs).

Some of the methods and assumptions mentioned above are based on the *18th Investigation of Actuarial Experience*, an actuarial experience study conducted by SERS to determine whether the assumptions used in its annual actuarial valuations remain accurate based on current and anticipated demographic trends and economic conditions. Published in March 2016, it analyzed experience from 2011 through 2016. The actuary, under oversight of the SERS Board, reviewed economic assumptions (such as the assumed future investment returns and salary increases) as well as demographic assumptions (such as employee turnover, retirement, disability, and death rates). Some assumption adjustments increased projected cost and some decreased projected cost, but the overall result was a slight increase to the net pension liability.

The long-term expected real rate of return on pension plan investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best estimates of arithmetic real rates of return for each major asset class included in SERS' current and target asset allocation as of December 31, 2015, are summarized below.

Asset Class	Target Allocation	Long-Term Expected Real Rate of Return
Alternative investments	15.00%	8.50%
Global public equity	40.00%	5.40%
Real assets	17.00%	4.95%
Diversifying assets	10.00%	5.00%
Fixed income	15.00%	1.50%
Liquidity reserve	3.00%	0.00%
	100.00%	

The discount rate used to measure the total SERS pension liability was 7.50%. The projection of cash flows used to determine the discount rate assumed that employee contributions will be made at the rates applicable for each member and that employer contributions will be made based on rates determined by the actuary and as set by statute. Based on those assumptions, SERS' fiduciary net position was projected to be available to make all projected future benefit payments of current and nonactive SERS members. The long-term expected rate of return on SERS' investments, therefore, was applied to all periods of projected benefit payments to determine the total pension liability.

The following presents the State System's proportionate share of the SERS net pension liability calculated using the discount rate of 7.50%, as well as what the SERS net pension liability would be if it were calculated using a discount rate that is one percentage point lower (6.50%) or one percentage point higher (8.50%) than the current rate.

Sensitivity of the State System's Proportionate Share of the SERS Net Pension Liability to Changes in the Discount Rate
(in thousands)

	1% Decrease 6.50%	Current Rate 7.50%	1% Increase 8.50%
2015	$1,066,316	$858,417	$680,156
2014	$931,943	$728,094	$552,817

Fiduciary Net Position
The fiduciary net positions of SERS, as well as additions to and deductions from SERS fiduciary

net positions, have been determined on the same basis as they are reported in the SERS financial statements, which can be found at www.sers.state.pa.us. The plan schedules of SERS are prepared using the accrual basis of accounting and economic resources measurement focus in accordance with U.S. GAAP as prescribed by GASB. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions are recognized when due and the employer has a legal requirement to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan. Investment purchases and sales are recorded on a trade-date basis. Detailed information on investment valuation can be found in the SERS financial statements. Management of SERS has made certain estimates and assumptions relating to employer allocation schedules, and actual results could differ.

Pension Liabilities, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions
At June 30, 2016, the amount recognized as the State System's proportionate share of the SERS net pension liability, measured at December 31, 2015, was $858,417,000. At June 30, 2015, the amount recognized as the State System's proportionate share of the SERS net pension liability, measured at December 31, 2014, was $728,094,000.

The allocation percentage assigned to each participating employer is based on a projected-contribution method. For the allocation of the 2015 amounts, this methodology applies the most recently calculated contribution rates for fiscal year 2016/17, from the December 31, 2015, funding valuation, to the expected funding payroll. For the allocation of the 2014 amounts, this methodology applies the most recently calculated contribution rates for fiscal year 2015/16, from the December 31, 2014, funding valuation, to the expected funding payroll. At the December 31, 2015, measurement date, the State System's proportion was 4.721%, a decrease of .018% from its proportion calculated as of the December 31, 2014, measurement date.

PSERS
Plan Description
PSERS is a governmental cost-sharing multiple-employer defined benefit pension plan that provides retirement, disability, and death benefits to public school employees of the Commonwealth. The members eligible to participate in PSERS include all full-time public school employees, part-time hourly public school employees who render at least 500 hours of service in the school year, and part-time per diem public school employees who render at least 80 days of service in the school year in any of the reporting entities in Pennsylvania. The Public School Employees' Retirement Code (Act No. 96 of October 2, 1975, as amended) (24 Pa. C.S. §§8101–8535) (the Code) is the authority by which PSERS benefits provisions and contribution requirements are established and may be amended. The Code requires contributions by active members, the employer (State System), and the Commonwealth. PSERS is a component unit of the Commonwealth and is included in the Commonwealth's financial report as a pension trust fund. PSERS issues a comprehensive annual financial report that may be obtained at www.psers.state.pa.us.

Benefits Provided
Members who joined prior to July 1, 2011, are eligible for monthly retirement benefits upon reaching age 62 with at least one year of credited service, age 60 with 30 or more years of credited service, or any age with 35 or more years of service. Act 120 preserved the benefits of members who joined prior to July 1, 2011, and introduced benefit reductions for individuals who become new members on or after July 1, 2011, by creating two new membership classes: Class T-E and Class T-F. To qualify for normal retirement, Class T-E and Class T-F members must complete a minimum of 35 years of service with a combination of age and service that totals 92 or greater, or they must work until age 65 with a minimum of three years of service.

Depending upon membership class, benefits are generally 2% or 2.5% of the member's final average salary (as defined in the Code) multiplied by the number of years of credited service. Members who joined prior to July 1, 2011, vest after completion of five years of service and may elect early retirement benefits. Class T-E and Class T-F members vest after completion of 10 years of service.

Participants are eligible for disability retirement benefits after completion of five years of credited service. Such benefits are generally equal to 2% or 2.5%, depending upon membership class, of the member's final average salary (as defined in the Code) multiplied by the number of years of credited service, but not less than one-third of such salary nor greater than the benefit the member would have had at normal retirement age. Members over normal retirement age may apply for disability benefits.

Death benefits are payable upon the death of an active member who has reached age 62 with at least one year of credited service (age 65 with at least three years of credited service for Class T-E and Class T-F members) or has at least five years of credited service (10 years for Class T-E and Class T-F members). Such benefits are actuarially equivalent to the benefit that would have been effective if the member had retired on the day before death.

Member Contributions
Active members who joined PSERS prior to July 22, 1983, contribute at 5.25% (Class T-C members) or at 6.50% (Class T-D members) of the member's qualifying compensation. Members who joined PSERS on or after July 22, 1983, and who were active or inactive as of July 1, 2001, contribute at 6.25% (Class T-C) or at 7.5% (Class T-D) of the member's qualifying compensation. Members who joined PSERS after June 30, 2001, and before July 1, 2011, contribute at 7.5% (Class T-D). For these hires and for members who elected Class T-D, the 7.5% contribution rate began with service rendered on or after January 1, 2002. Members who joined PSERS after June 30, 2011, contribute at the rate of 7.5% (Class T-E) or 10.3% (Class T-F) of their qualifying compensation. Class T-E and Class T-F members are subject to a "shared risk" provision in Act 120 that could cause the rate in future years to fluctuate between 7.5% and 9.5% for Class T-E and 10.3% and 12.3% for Class T-F.

Employer Contributions
The State System's contractually required contribution rate for PSERS for fiscal year ended June 30, 2016, was 25.0% of covered payroll, actuarially determined as an amount that, when combined with employee contributions, is expected to finance the costs of benefits earned by employees during the year, with an additional amount to finance any unfunded accrued liability. Per §8327 of the Code, the Commonwealth is required to contribute 50% of the contribution rate directly to PSERS on behalf of the State System, meaning that the amount that the State System actually contributed was 12.5% of covered payroll. The State System's contribution to PSERS for the year ending June 30, 2016, June 30, 2015, and June 30, 2014 was $6,012,000, $5,236,000, and $3,940,000, respectively, equal to the required contractual contribution.

Actuarial Assumptions
The total PSERS pension liability as of June 30, 2015, was determined by rolling forward PSERS' total pension liability as of the June 30, 2014, actuarial valuation to June 30, 2015, using the following actuarial assumptions, applied to all periods included in the measurement.

- Actuarial cost method is entry age normal, level percent of pay.
- Inflation of 3%.
- Investment return of 7.50%, including inflation.
- Salary increases based on an effective average of 5.5%, which reflects an allowance for inflation, real wage growth of 1.0%, and merit or seniority increases of 1.50%.
- Mortality rates based on the RP-2000 Combined Healthy Annuitant Tables (male and female) with age set back three years for both males and females; for disabled annuitants, the RP-2000 Combined Disabled Tables (male and female) with age set back seven years for males and three years for females.

The actuarial assumptions used in the June 30, 2014, valuation were based on the experience study that was performed for the five-year period ending June 30, 2010. The recommended assumption changes based on this experience study were adopted by the PSERS Board of Trustees at its March 11, 2011, meeting and were effective beginning with the June 30, 2011, actuarial valuation.

The long-term expected rate of return on pension plan investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation.

PSERS' policy in regard to the allocation of invested plan assets is established and may be amended by the PSERS Board of Trustees. Plan assets are managed with a long-term objective of achieving and maintaining a fully funded status for the benefits provided through the pension. Following is the PSERS Board of Trustees' adopted asset allocation policy and best estimates of geometric real rates of return for each major asset class as of June 30, 2015.

Asset Class	Target Allocation	Long-Term Expected Real Rate of Return
Public markets global equity	22.5%	4.8%
Private markets (equity)	15.0%	6.6%
Private real estate	12.0%	4.5%
Global fixed income	7.5%	2.4%
U.S. long treasuries	3.0%	1.4%
TIPS	12.0%	1.1%
High-yield bonds	6.0%	3.3%
Cash	3.0%	0.7%
Absolute return	10.0%	4.9%
Risk parity	10.0%	3.7%
MLPs/Infrastructure	5.0%	5.2%
Commodities	8.0%	3.1%
Financing (LIBOR)	(14.0%)	1.1%
	100.0%	

The discount rate used to measure the total PSERS pension liability was 7.50%. The projection of cash flows used to determine the discount rate assumed that contributions from plan members will be made at the current contribution rate and that contributions from employers will be made at contractually required rates, actuarially determined. Based on those assumptions, PSERS' fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on PSERS' investments was applied to all periods of projected benefit payments to determine the total pension liability.

The following presents the State System's proportionate share of the PSERS net pension liability calculated using the discount rate of 7.50%, as well as what the PSERS net pension liability would be if it were calculated using a discount rate that is one percentage point lower (6.50%) or one percentage point higher (8.50%) than the current rate.

Sensitivity of the State System's Proportionate Share of the PSERS Net Pension Liability to Changes in the Discount Rate
(in thousands)

	1% Decrease 6.50%	Current Rate 7.50%	1% Increase 8.50%
2015	$98,879	$80,220	$64,537
2014	$88,128	$70,650	$55,731

Fiduciary Net Position

For purposes of measuring the net pension liability, deferred outflows of resources, and deferred inflows of resources related to pensions and pension expense, the fiduciary net position of PSERS and additions to or deductions from PSERS' fiduciary net position have been determined on the same basis as they are reported in the PSERS' financial statements. For this purpose, benefit payments, including refunds of employee contributions, are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value. Detailed information about PSERS' fiduciary net position is available in the PSERS Comprehensive Annual Financial Report, which can be found at www.psers.state.pa.us.

Pension Liabilities, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions

The amount recognized as the State System's proportionate share of the PSERS net pension liability, plus the related PSERS pension support provided by the Commonwealth, is as follows.

(in thousands)	2016	2015
Total PSERS net pension liability associated with the State System	$160,440	$141,300
Commonwealth's proportionate share of the PSERS net pension liability associated with the State System	80,220	70,650
State System's proportionate share of the PSERS net pension liability	$80,220	$70,650

PSERS measured the net pension liability as of June 30, 2015. The total PSERS pension liability used to calculate the net pension liability was determined by rolling forward the total pension liability calculated as of June 30, 2014, to June 30, 2015. PSERS calculated the employer's proportion of the net pension liability using the employer's one-year reported covered payroll in relation to all participating employers' one-year reported covered payroll. At June 30, 2015, the State System's proportion was .1852%, an increase of .0067% from its proportion calculated as of June 30, 2014.

ARP

The ARP is a defined contribution plan administered by the State System. 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 recognizes annual pension expenditures equal to its contractually required contributions to the plan. The State System's contribution rate on June 30, 2016 and 2015, was 9.29% of qualifying compensation. The contributions to the ARP for the years ended June 30, 2016 and 2015, were $43,933,000 and $44,619,000, respectively, from the State System; and $24,022,000 and $23,903,000, respectively, from active members. No liability is recognized for the ARP.

(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), Office and Professional Employees International Union (OPEIU), 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 $40,060,000 and $36,869,000 for the fiscal years ending June 30, 2016 and 2015, 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, 2016.

- 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.
- Eligible annuitants who retired on or after July 1, 2005, and prior to July 1, 2008, and who are under age 65 pay the same dollar amount they paid as active employees on the day of retirement. When these annuitants become eligible for Medicare, they pay 18% 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.
- Eligible annuitants who retire on or after July 1, 2008, pay 18% of the plan premium in effect for active employees on their retirement date. Future adjustments will apply if contributions increase for active employees.
- Employee members of SPFPA, OPEIU, and SCUPA, and nonrepresented employees, hired after January 15, 2016, receive no postretirement benefits.

Total contributions made by plan members were $4,866,000 and $4,272,000, or approximately 10.8% and 10.4% of the total premiums, for the fiscal years ending June 30, 2016 and 2015, 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, 2016**	**June 30, 2015**
Annual required contribution	$102,000	$102,000
Interest on net OPEB obligation	44,690	42,800
Adjustment to ARC	(58,736)	(56,253)
Annual OPEB cost (expense)	87,954	88,547
Contributions made	(40,060)	(36,869)
Increase in net OPEB obligation	47,894	51,678
Net OPEB obligation at July 1	1,058,749	1,007,071
Net OPEB obligation at June 30	$1,106,643	$1,058,749

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, 2016, 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, 2014	$117,582	37.6%	$1,007,071
June 30, 2015	$88,547	41.6%	$1,058,749
June 30, 2016	$87,954	45.6%	$1,106,643

Funded Status and Funding Progress
The funded status of the plan as of July 1, 2014, the most recent actuarial valuation date, was as follows.

(in thousands)	
Actuarial accrued liability (AAL)	$1,194,849
Actuarial value of plan assets	0
Unfunded actuarial accrued liability (UAAL)	$1,194,849
Funded ratio (actuarial value of plan assets/AAL)	0%
Covered payroll (active plan members)	$589,917
UAAL as a percentage of covered payroll	203%

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, 2014, actuarial valuation, the projected unit credit method was used with a 4.25% investment rate of return, which is the rate expected to be earned on the State System's operating portfolio. The health care cost trend rate used was 6.5% in 2014, 6.0% in 2015, and 5.5% in 2016 through 2020, with rates gradually decreasing from 5.4% in 2021 to 3.8% in 2075 and later based on the Society of Actuaries Long-Run Medical Cost Trend Model. The UAAL is being amortized as a level percentage of payroll on a closed basis. The remaining amortization period at July 1, 2014, was 21 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 2015/16, the State System contributed $418 for each current active employee per biweekly pay period. The State System made contributions of $37,026,000, $30,765,000, and $28,584,000 for the fiscal years ending June 30, 2016, 2015, and 2014, 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 $372,000, $1,405,000, and $1,875,000 to the Reserve Fund during the years ended June 30, 2016, 2015, and 2014, respectively.

For the years ended June 30, 2016, 2015, and 2014, the aggregate liability for claims under the self-insurance limit was $9,345,000, $9,825,000, and $9,902,000, respectively. The Reserve Fund assets of $12,746,000, $12,724,000, and $11,808,000 are equal to the liability for claims in excess of the self-insurance limits for the years ended June 30, 2016, 2015, and 2014, respectively. Changes in the workers' compensation claims liability in fiscal years 2016, 2015, and 2014 follow.

(in thousands)

Year	Beginning Balance	Current Year Claims and Changes in Estimates	Claim Payments	Ending Balance
2014	$21,344	$5,244	$4,878	$21,710
2015	$21,710	$5,177	$4,337	$22,550
2016	$22,550	$3,465	$3,924	$22,091

(7) Compensated Absences

Changes in the compensated absences liability in fiscal years 2016 and 2015 are as follows.

(in thousands)

Year	Beginning Balance	Current Changes in Estimates	Less Payouts	Ending Balance
2015	$114,710	$11,272	$11,342	$114,640
2016	$114,640	$9,799	$9,016	$115,423

(8) Bonds Payable

Bonds payable on June 30, 2016 and 2015, 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.

Activity for the various bond series for the years ended June 30, 2016 and 2015, was as follows.

Bonds Payable
June 30, 2016 and 2015
(in thousands)

Description	Original Issuance	Weighted Average Interest Rate	Balance June 30, 2014	2015 Bonds Issued	2015 Bonds Redeemed/ Refunded	Balance June 30, 2015	2016 Bonds Issued	2016 Bonds Redeemed/ Refunded	Balance June 30, 2016	Current Portion
Series AC issued July 2005, final maturity June 2025	$52,650	N/A	$31,095	-	$31,095	-	-	-	-	-
Series AE issued July 2006, final maturity June 2036	103,290	N/A	75,805	-	75,805	-	-	-	-	-
Series AF issued July 2007, final maturity June 2037	68,230	5.00%	54,525	-	2,305	$52,220	-	$52,220	-	-
Series AG issued March 2008, final maturity June 2024	101,335	4.81%	70,505	-	10,875	59,630	-	11,485	$48,145	$12,075
Series AH issued July 2008, final maturity June 2038	140,760	4.66%	119,005	-	4,220	114,785	-	4,435	110,350	4,655
Series AI issued August 2008, final maturity June 2025	32,115	4.21%	21,725	-	1,845	19,880	-	1,910	17,970	1,990
Series AJ issued July 2009, final maturity June 2039	123,985	4.88%	105,285	-	4,835	100,450	-	5,245	95,205	5,685
Series AK issued Sept. 2009, final maturity June 2024	47,310	4.00%	32,240	-	3,795	28,445	-	3,910	24,535	4,080
Series AL issued July 2010, final maturity June 2035	135,410	5.00%	90,065	-	7,710	82,355	-	7,935	74,420	8,000
Series AM issued July 2011, final maturity June 2036	119,085	4.64%	108,170	-	4,200	103,970	-	4,420	99,550	4,655
Series AN issued March 2012, final maturity June 2023	76,810	5.00%	75,365	-	4,000	71,365	-	8,235	63,130	9,430
Series AO issued July 2013, final maturity June 2038	30,915	4.32%	29,995	-	1,040	28,995	-	1,075	27,880	1,105
Series AP issued May 2014, final maturity June 2024	46,110	4.51%	46,110	-	2,685	43,425	-	2,940	40,485	1,200
Series AQ issued May 2015, final maturity June 2036	94,975	4.70%	-	$94,975	-	94,975	-	1,880	93,095	6,685
Series AR issued Sept. 2015, final maturity June 2040	102,365	4.01%	-	-	-	-	$102,365	1,820	100,545	2,475
Series AS issued June 2016, final maturity June 2037	47,280	3.72%	-	-	-	-	47,280	-	47,280	850
Total	**$1,322,625**	**-**	**$859,890**	**$94,975**	**$154,410**	**$800,455**	**$149,645**	**$107,510**	**$842,590**	**$62,885**

Principal and interest requirements to maturity are as follows.

(in thousands)

	Principal	Interest	Total
2017	$62,885	$38,570	$101,455
2018	63,505	35,525	99,030
2019	67,935	32,543	100,478
2020	75,290	29,399	104,689
2021	59,025	25,926	84,951
2022–2026	261,165	88,074	349,239
2027–2031	143,720	40,059	183,779
2032–2036	78,960	15,083	94,043
2037–2040	30,105	2,815	32,920
Total	**$842,590**	**$307,994**	**$1,150,584**

(9) Debt Refunding

In June 2016, the net proceeds from the Series AS revenue bonds were used to purchase U.S. Government Securities that were deposited irrevocably in trust with an escrow agent to advance refund the Series AF revenue bonds. Although it resulted in an accounting loss of $1,115,000, the refunding was performed to reduce debt service by approximately $8,842,000 and resulted in an economic gain (difference between the present values of the old and new debt service payments) of approximately $7,469,000. The accounting loss, or deferred loss on refunding, is reported as a deferred outflow of resources. As of June 30, 2016, $49,800,000 of Series AF revenue bonds remained outstanding, and the fair market of the escrow account was $51,934,000. The funds in escrow will be used to pay the December 15, 2016, interest payment and the June 15, 2017, principal and interest payment of Series AF. Neither the funds in escrow nor the outstanding balance of Series AF is reflected on the balance sheet.

(10) Rating Actions

The State System's outstanding bonds are assigned an Aa3 rating from Moody's Investors Service, Inc. In August 2016, Moody's revised the outlook for the rating from *negative* to *stable.* Fitch Ratings reaffirmed the State System's rating of AA- with an outlook of *stable*.

(11) Capital Assets

The classifications of capital assets and related depreciation at June 30, 2016 and 2015, follow.

(in thousands)	Balance June 30, 2014	2014/15 Additions	2014/15 Retirements/ Adjustments	Balance June 30, 2015	2015/16 Additions	2015/16 Retirements/ Adjustments	Balance June 30, 2016
Land	$32,360	-	-	$32,360	-	-	$32,360
Construction in progress	70,206	$65,737	($36,799)	99,144	$56,475	($75,607)	80,012
Total capital assets not being depreciated	102,566	65,737	(36,799)	131,504	56,475	(75,607)	112,372
Buildings, including improvements	2,039,800	18,588	(2,203)	2,056,185	101,691	55,587	2,213,463
Improvements other than buildings	264,498	4,414	5,867	274,779	7,472	2,885	285,136
Equipment and furnishings	454,757	15,292	(15,921)	454,128	24,278	(8,059)	470,347
Library books	83,690	894	(2,644)	81,940	869	(1,495)	81,314
Total capital assets being depreciated	2,842,745	39,188	(14,901)	2,867,032	134,310	48,918	3,050,260
Less accumulated depreciation:							
Buildings and improvements	(777,255)	(79,045)	13,342	(842,958)	(82,671)	8,923	(916,706)
Land improvements	(121,584)	(10,379)	439	(131,524)	(9,355)	1,593	(139,286)
Equipment and furnishings	(355,366)	(28,215)	22,374	(361,207)	(27,789)	9,681	(379,315)
Library books	(74,298)	(2,013)	2,648	(73,663)	(1,868)	1,495	(74,036)
Total accumulated depreciation	(1,328,503)	(119,652)	38,803	(1,409,352)	(121,683)	21,692	(1,509,343)
Total capital assets being depreciated, net	1,514,242	(80,464)	23,902	1,457,680	12,627	70,610	1,540,917
Capital assets, net	$1,616,808	($14,727)	($12,897)	$1,589,184	$69,102	($4,997)	$1,653,289

(12) Deferred Outflows of Resources and Deferred Inflows of Resources

The classifications of deferred outflows of resources and deferred inflows of resources at June 30, 2016 and 2015, follow.

(in thousands)	June 30, 2016	June 30, 2015
Deferred Outflows of Resources		
Net pension liability related (see note 4)	$182,057	$64,207
Unamortized loss on refunding of debt	9,164	9,349
Total Deferred Outflows of Resources	$191,221	$73,556
Deferred Inflows of Resources		
Net pension liability related (see note 4)	$29,089	$14,100
Unamortized gain on refunding of debt	1,073	1,211
Total Deferred Inflows of Resources	$30,162	$15,311

(13) 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, 2016, 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, with the exception of potential adjustments related to Cheyney University of Pennsylvania, as detailed in the following section.

Cheyney University of Pennsylvania
In August 2015, the State System completed an analysis and reconciliation of almost 4,400 student accounts at Cheyney University for fiscal years 2011/12, 2012/13, and 2013/14. It was determined that, as a result of deficiencies in the university's policies, processes, and procedures related to the financial aid function, noncompliance with federal regulations in the administration and delivery of federal financial aid totaled $29.6 million over the three years. The State System, which undertook the analysis in consultation with the U.S. Department of Education (ED), self-reported the findings to the ED in August 2015. The ED has not yet given its determination of any amounts to be repaid; however, in September 2015 it placed the university on Heightened Cash Monitoring 2 (HCM2) status, meaning that the university no longer receives federal financial aid funds under the advance payment method, but instead must make financial aid disbursements to students from its own institutional funds and request reimbursement from the ED. The delayed receipt of funds, combined with continued enrollment declines, has resulted in a significant drop in cash that has not been matched with a corresponding drop in expenses, exacerbating the university's severe cash flow problems. The State System has appealed to the ED to remove the university from HCM2 status, citing the improvement of financial aid administration under the leadership of the Office of the Chancellor and a third-party consultant as well as other improvements in administration.

In January 2016, the U.S. Department of Justice (DOJ) notified the State System that it was investigating the application and use of federal student financial aid by Cheyney University and the oversight of the university by the State System. The DOJ requested that the university and State System preserve and produce certain documents. The State System has fully complied with DOJ's request. No action has been taken at this point by the DOJ, and the possible resulting outcomes from the investigation are uncertain until communication is received from the DOJ.

In November 2015, the Middle States Commission on Higher Education (Middle States) placed Cheyney University on probation "because of insufficient evidence that the institution is currently in compliance with Standard 3 (Institutional Resources)." Standard 3 requires, among other things, that an institution demonstrate that it has sufficient resources to support both its programs of study and students' academic progress. As required by Middle States, the university submitted a monitoring report on September 1, 2016, documenting the implementation of a technology plan, the development and implementation of a long-term financial plan, steps taken to strengthen the institution's finances, and cash and financial projections for the next five years. As further required, the report details steps taken to assure continuity and stability of institutional leadership and the use of assessment results to improve programs and services.

To address the above, the university has furloughed senior management employees and realigned staff positions and responsibilities. It has discontinued seven graduate degree programs and eight baccalaureate degree programs, and has placed another 11 undergraduate degree programs into moratorium status while students are being taught out. The university continues to contract with the third-party consultant who completed the financial aid analysis to provide full service administration of the university's federal financial aid programs and functions. With assistance from the Office of the Chancellor, the university has contracted with a third party to administer its information technology systems and has begun the outsourcing of its administrative functions, including finance, human resources, and facilities, to nearby West Chester University of Pennsylvania. This outsourcing, which is expected to improve services and achieve costs savings, will be fully implemented by spring 2017.

Insurance
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, 2016 and 2015, were approximately $91,192,000 and $69,604,000, respectively.

(14) Subsequent Events

In September 2016, PHEFA issued Series AT-1 tax-exempt revenue bonds in the amount of $279,050,000 and Series AT-2 taxable revenue bonds in the amount of $19,060,000. The net proceeds from the Series AT revenue bonds were used to finance capital projects at several universities and to purchase certain student housing projects constructed by respective affiliated organizations. In connection with the bond issuance, the State System entered into a loan agreement with PHEFA under which the State System pledged its full faith and credit for repayment of bonds.

In September 2016, after more than a year of contract negotiations with the State System, the Association of Pennsylvania State College and University Faculties (APSCUF), which represents all faculty and coaches, voted to authorize union leaders to call a strike if and when it is considered necessary. APSCUF has been working under the terms of a contract that expired June 30, 2015. The short- or long-term financial impact of a strike on the universities and their students cannot be estimated but could be severely detrimental. As of the date of these financial statements, negotiations between the State System and APSCUF are continuing.

REQUIRED SUPPLEMENTARY INFORMATION

Years Ended June 30, 2016 and 2015

(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, 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%
July 1, 2014	$0	$1,194,849	$1,194,849	0%	$589,917	203%

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, 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%
January 1, 2015	$144,744	$16,134,419	$15,989,675	.90%	$4,289,000	373%

Schedule of Proportionate Share of SERS Net Pension Liability (NPL)

Determined as of SERS December 31 measurement date
(in thousands)

Fiscal Year	State System's Proportion	State System's Proportionate Share	State System's Covered-Employee Payroll	State System's Proportionate Share of NPL as a Percentage of Covered-Employee Payroll	SERS Fiduciary Net Position as a Percentage of Total Pension Liability
2014/15	4.901%	$728,094	$296,967	245%	64.8%
2015/16	4.721%	$858,417	$297,714	288%	58.9%

SERS Schedule of Contributions

Determined as of State System June 30 fiscal year end
(in thousands)

Fiscal Year	Contractually Required Contributions	Contributions Recognized by SERS in FY 2014/15	Contribution Deficiency (Excess)	Covered-Employee Payroll	Contributions as a Percentage of Covered-Employee Payroll
2014/15	$57,234	$57,234	$0	$293,506	19.50%
2015/16	$69,021	$69,021	$0	$291,594	23.67%

Schedule of Proportionate Share of PSERS Net Pension Liability

Determined as of PSERS June 30 measurement date
(in thousands)

	PSERS Net Pension Liability						
Fiscal Year	State System's Proportion	State System's Proportionate Share	Commonwealth's Proportionate Share	Total	State System's Covered-Employee Payroll	State System's Proportionate Share of NPL as a Percentage of Covered-Employee Payroll	PSERS Fiduciary Net Position as a Percentage of Total Pension Liability
2014/15	.1785%	$70,650	$70,650	$141,350	$45,552	155%	57.2%
2015/16	.1852%	$80,220	$80,220	$160,440	$47,670	168%	54.4%

PSERS Schedule of Contributions

Determined as of State System June 30 fiscal year end
(in thousands)

Fiscal Year	Contractually Required Contributions	Contributions Recognized by PSERS in FY 2014/15	Contribution Deficiency (Excess)	Covered-Employee Payroll	Contributions as a Percentage of Covered-Employee Payroll
2014/15	$5,236	$5,236	$0	$51,086	10.25%
2015/16	$6,012	$6,012	$0	$48,419	12.41%

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