KPMG

UNIVERSITY OF SOUTH ALABAMA

(A Component Unit of the State of Alabama)

Basic Financial Statements and Supplementary Information
on Federal Awards Programs

September 30, 2006

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

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UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Management's Discussion and Analysis (Unaudited)

September 30, 2006 and 2005

Introduction

The following discussion presents an overview of the financial position and financial activities of the University of South Alabama (the University), including the University of South Alabama Hospitals (the Hospitals), a division of the University, at September 30, 2006 and 2005 and for the years then ended. This discussion was prepared by University management and should be read in conjunction with the financial statements and notes thereto, which follow.

The basic financial statements of the University consist of the University and its component units. The financial position and results of operations of the component units are either blended with the University's financial position and results of operations or are discretely presented. The treatment of each component unit is governed by pronouncements issued by the Governmental Accounting Standards Board. As more fully described in footnote number one to the basic financial statements, the University of South Alabama Professional Liability Trust Fund and the University of South Alabama General Liability Trust Fund are reported as blended component units. The University of South Alabama Foundation and the University of South Alabama Health Services Foundation are discretely presented.

Financial Highlights

At September 30, 2006, 2005 and 2004, the University has total assets of $546,150,000, $485,986,000, and $460,180,000, respectively; total liabilities of $234,792,000, $230,030,000, and $226,070,000, respectively; and net assets of $311,358,000, $255,956,000, and $234,110,000, respectively. University net assets increased $55,402,000 during the year ended September 30, 2006 compared to increases of $21,846,000 and $15,918,000 in the years ended September 30, 2005 and 2004, respectively.

An overview of each statement is presented herein along with a financial analysis of the transactions impacting each statement. Where appropriate, comparative financial information is presented to assist in the understanding of this analysis.

Analysis of Financial Position and Results of Operations

Statement of Net Assets

The statement of net assets presents the assets, liabilities, and net assets of the University at September 30, 2006 and 2005. The net assets are displayed in three parts: invested in capital assets, net of related debt, restricted and unrestricted. Restricted net assets may either be expendable or nonexpendable and are those assets that are restricted by law or external donor. Unrestricted net assets, while they are generally designated for specific purposes, are available for use by the University to meet current expenses for any purpose. The statement of net assets, along with all of the University's basic financial statements, are prepared under the economic resources measurement focus and the accrual basis of accounting, whereby revenues are recognized when earned and expenses are recognized when incurred by the University, regardless of when cash is exchanged.

Assets included in the statement of net assets are classified as current or noncurrent. Current assets consist primarily of cash and cash equivalents, investments, and hospital patient accounts receivable. Of these amounts, cash and cash equivalents, investments, and accounts receivable comprise approximately 16%, 57%, and 24% respectively, of current assets at September 30, 2006. Noncurrent assets at September 30, 2006 consist primarily of capital assets.

The Condensed Schedule of Net Assets at September 30, 2006, 2005 and 2004 follows (in thousands):

Condensed Schedule of Net Assets

	2006	2005	2004
Assets:			
Current	$ 223,913	169,358	161,931
Capital assets	247,875	231,027	216,767
Other noncurrent	74,362	85,601	81,482
Total assets	546,150	485,986	460,180
Liabilities:			
Current	71,071	72,834	66,381
Noncurrent	163,721	157,196	159,689
Total liabilities	234,792	230,030	226,070
Net assets:			
Invested in capital assets, net of related debt	137,642	127,805	116,037
Restricted, nonexpendable	12,612	12,208	10,372
Restricted, expendable	25,966	9,997	7,150
Unrestricted	135,138	105,946	100,551
Total net assets	$ 311,358	255,956	234,110

University cash, cash equivalents, and investments (current and noncurrent) increased between September 30, 2006 and 2005 by $33,928,000 to $218,083,000. This increase is primarily due to increases in state appropriations, investment income and gifts to the University. This follows a significant increase between 2004 and 2005, which resulted from cash generated by the issuance of the University's Series 2004 Tuition Revenue Refunding and Capital Improvement Bonds and from proceeds from the sale of two buildings, one to the USA Research and Technology Corporation and one to an unrelated party. Patient accounts receivable decreased from $31,245,000 to $26,399,000 between 2005 and 2006, reflecting the lease of USA Knollwood Hospital to the Infirmary Health Systems, as discussed later in this analysis. Noncurrent accounts receivable increased from $0 to $8,316,000 between 2005 and 2006 as the result of an increase in pledges receivable related to the Mitchell Cancer Institute.

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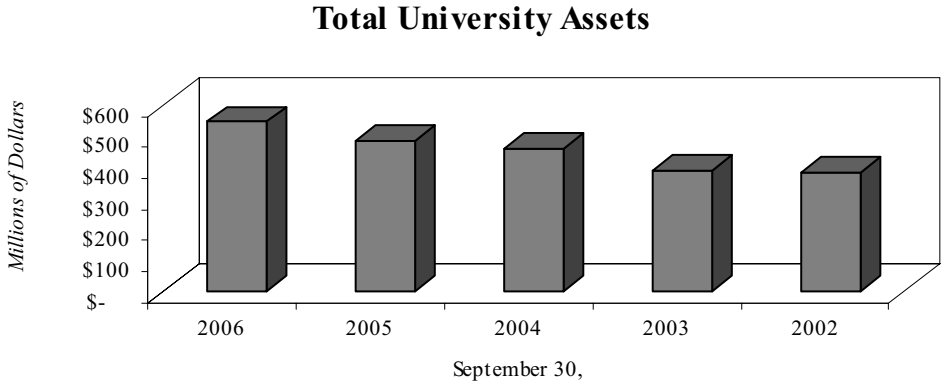
Total assets of the University as of September 30 are as follows:



Noncurrent liabilities consist primarily of bonded indebtedness and notes payable. Long-term debt decreased from $127,133,000 to $122,470,000 between September 30, 2005 and 2006 primarily as a result of a repayment of principal on notes and bonds payable. A similar decrease occurred between 2004 and 2005. Other noncurrent liabilities increased to $48,240,000 at September 30, 2006 primarily as a result of deferred revenue recorded as part of the lease transaction with Infirmary Health System, Inc.

Net assets represent the residual interest in the University's assets after liabilities are deducted. Net assets are classified into one of four categories:

Net assets invested in capital assets, net of related debt, represent the University's capital assets less accumulated depreciation and outstanding principal balances of the debt attributable to the acquisition, construction, or improvement of those assets.

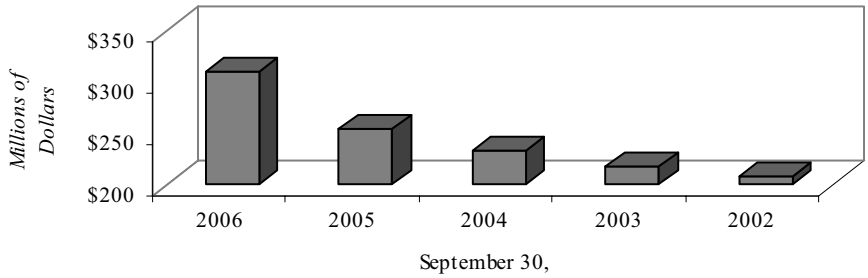
Restricted nonexpendable net assets consist primarily of the University's permanent endowment funds. While earnings from these funds may be expended, the corpus may not be expended for any reason and must remain intact with the University in perpetuity.

Restricted expendable net assets are subject to externally imposed restrictions governing their use. The funds are restricted primarily for debt service, capital projects, student loans, and scholarship purposes.

Unrestricted net assets represent those net assets not subject to externally imposed stipulations. Even though these funds are not legally restricted, the majority of the University's unrestricted net assets have been internally designated for various projects, all supporting the missions of the University. These unrestricted net assets include funds for various academic and research programs, auxiliary operations (including the bookstore, student housing and dining services), student programs, capital projects and general operations.

Net assets of the University for the last four years are as follows:

Net University Assets



Net assets invested in capital assets, net of related debt, increased approximately $9,837,000 between September 30, 2005 to 2006. This increase was due primarily to an increase in construction activity and the repayment of principal on notes and bonds payable. Restricted expendable net assets increased to $25,966,000 at September 30, 2006 primarily due to restricted non-endowed gift activity primarily related to the Mitchell Cancer Institute. Unrestricted net assets increased from $105,946,000 to $135,138,000 between 2005 and 2006 primarily as the result of increases in state appropriations and unrestricted gifts.

Statement of Revenues, Expenses, and Changes in Net Assets

Changes in total University net assets as reported in the statement of net assets are based on the activity presented in the statement of revenues, expenses, and changes in net assets. The purpose of this statement is to present the change in net assets resulting from revenues earned by the University, both operating and nonoperating, and the expenses incurred by the University, both operating and nonoperating, as well as any other revenues, expenses, gains, and losses earned or incurred by the University.

Generally, operating revenues have the characteristics of exchange transactions and are received or accrued for providing goods and services to the various customers and constituencies of the University. These include hospital patient care services, tuition and fees (net of scholarship discounts and allowances), most noncapital grants and contracts and revenues from auxiliary activities and sales and services of education activities (primarily athletic activities). Operating expenses are those expenses paid or incurred to acquire or produce the goods and services provided in return for the operating revenues, and to carry out the mission of the University.

Nonoperating revenues have the characteristics of nonexchange transactions and are revenues generally earned for which goods and services are not provided, such as investment income, capital appropriations, gifts and other contributions. State appropriations are required by the Governmental Accounting Standards Board to be classified as nonoperating revenues. Nonoperating expenses are those expenses required in the operation and administration of the University, but not directly incurred to acquire or produce the goods and services provided in the return for operating revenues. Such nonoperating expenses include interest on the University's indebtedness and losses related to the disposition of capital assets.

The Condensed Schedule of Revenues, Expenses, and Changes in Net Assets for the years ended September 30, 2006, 2005 and 2004 follows (in thousands):

Condensed Schedule of Revenues, Expenses, and Changes in Net Assets

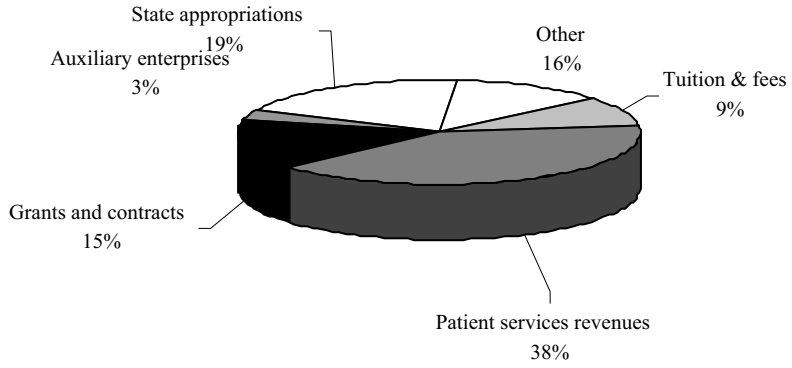
	2006	2005	2004
Operating revenues:			
Tuition and fees	$ 47,236	43,737	38,832
Net patient service revenue	201,373	201,413	192,520
Federal, state and private grants and contracts	78,217	68,647	72,228
Other	47,533	45,915	43,671
	374,359	359,712	347,251
Operating expenses:			
Salaries and benefits	317,626	307,039	292,089
Supplies and other services	109,653	105,116	106,564
Other	35,336	32,432	31,913
	462,615	444,587	430,566
Operating loss	(88,256)	(84,875)	(83,315)
Nonoperating revenues (expenses):			
State appropriations	101,203	86,622	84,233
Investment income	9,418	7,121	3,789
Other, net	23,250	3,281	(1,982)
Net nonoperating revenues	133,871	97,024	86,040
Income before capital contributions and additions to endowment	45,615	12,149	2,725
Capital contributions and additions to endowment	9,787	9,697	13,193
Increase in net assets	55,402	21,846	15,918
Beginning net assets	255,956	234,110	218,192
Ending net assets	$ 311,358	255,956	234,110

(Continued)

In 2006, 2005 and 2004, approximately 54%, 56%, and 55%, respectively, of operating revenues of the University were net patient service revenue. Excluding net patient service revenue, state appropriations represent the largest component of total university revenues, approximately 19% of total revenues in fiscal 2006. Also in 2006 tuition and fees charged to students and grants and contracts (federal, state and private) represented approximately 9% and 15% of total revenues, respectively.

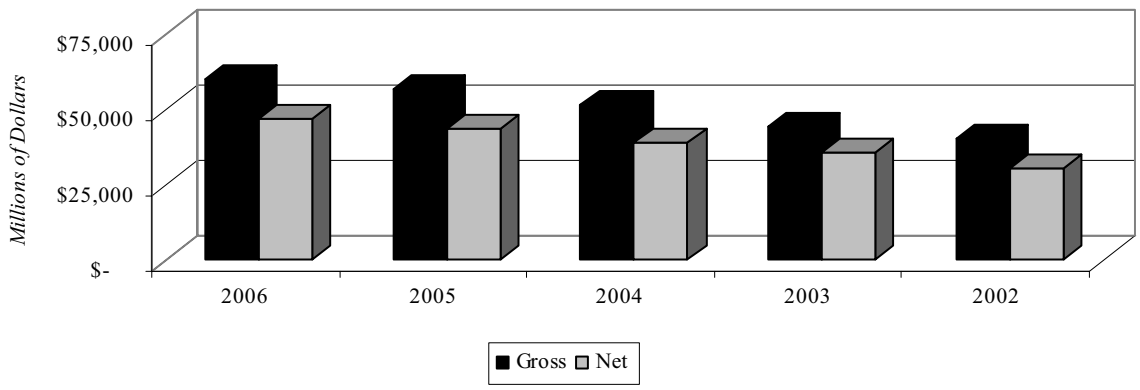
A summary of University revenues for the year ended September 30, 2006 is presented below:

Total Revenues



Tuition and fees have increased significantly in each of the last four years. These increases are due to increases in tuition and fee rates charged to students as well as to an increase in the number of students enrolled. Additionally, tuition and fees as a percent of total operating revenue (excluding state appropriations) continue to increase, from 9.5% of operating revenues in 2002 to 12.6% in 2006. Tuition and fees, gross and net of scholarship allowances, for the past five fiscal years are as follows:

Tuition and Fees



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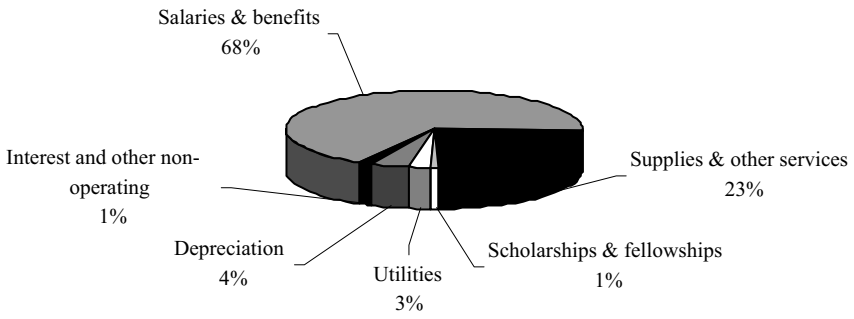
Further, other nonoperating revenues increased from approximately $9,238,000 in 2005 to $30,263,000 in 2006 primarily due to significant increases in gift revenue, including major gifts to the Mitchell Cancer Institute. Financial market conditions have resulted in significant increases in investment income from $3,789,000 in 2004 to $7,121,000 in 2005 and $9,418,000 in 2006.

University expenses are presented using their natural expense classifications. A summary of University expenses for the year ended September 30, 2006 is presented below.

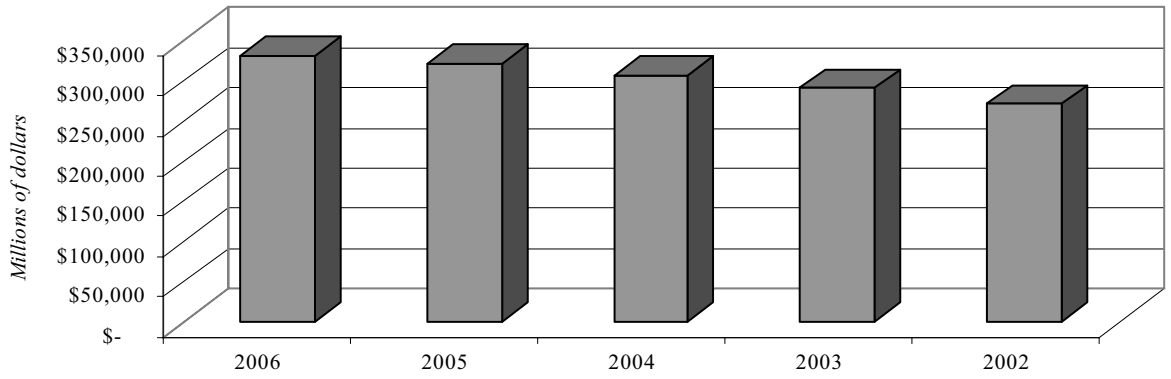
Total Expenses



While the University reports its expenses on a natural expense classification basis, functional classifications represent expenses categorized based on the function within the University. Such University functions include instruction, research, public service, academic support, student services, institutional support, scholarships, and operation and maintenance of plant. Expenses related to auxiliary enterprise activities and the hospitals are presented separately. Functional expense information is presented in footnote 15 to the basic financial statements.

In 2006, 2005 and 2004, approximately 69%, 69%, and 68%, respectively, of the University's total operating expenses were salaries and benefits. Salaries and benefits have steadily increased over the last five years, resulting primarily from increases in salary rates to faculty and staff, as shown below:

Total Salaries and Benefits Expense

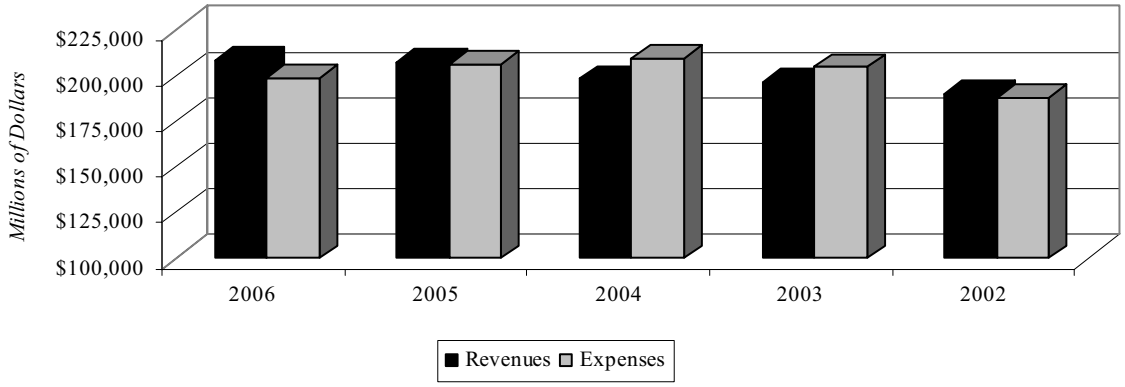


For the years ended September 30, 2006, 2005 and 2004, the University reported an operating loss of approximately $88,256,000, $84,875,000, and $83,315,000, respectively. Net operating losses are offset by state appropriations, which are reported as nonoperating revenue. After adding state appropriations and other nonoperating revenues and expenses, (primarily capital contributions and additions to endowment) the total increase in net assets was approximately $55,402,000, $21,846,000, and $15,918,000 for the years ended September 30, 2006, 2005 and 2004, respectively.

(Continued)

The Hospitals represent approximately half of total University revenues and expenses, which have remained relatively constant over the past four years. Operating hospital revenues and expenses for the last four fiscal years have not changed significantly and are presented below:

Hospital Operating Revenues and Expenses



Statement of Cash Flows

The statement of cash flows presents information related to cash flows of the University. This statement presents cash flows by category: operating activities, noncapital financing activities, capital and related financing activities and investing activities. The net cash provided to, or used by, the University is presented by category.

Capital Assets and Debt Administration

Total capital asset additions for the University were approximately $37,000,000, $33,000,000 and $23,000,000 during the years ended September 30, 2006, 2005 and 2004, respectively. Significant capital asset additions in fiscal 2006 include the completion of Meisler Hall (Student Services Building), significant construction-in-progress related to the Mitchell Cancer Institute and numerous ongoing construction projects at the University and Hospitals. Significant projects in fiscal 2004 and 2005 included Buildings I and II in the USA Research Park, JagTran (the campus shuttle system) and ongoing projects. In 2004, the initial building of the USA Technology and Research Park was sold to the USA Research and Technology Corporation and a former dormitory located at 1500 Government Street was sold to an unrelated party. The total proceeds from these sales were approximately $11,900,000. At September 30, 2006, the University has outstanding commitments of approximately $30,042,000 for various capital projects.

In December 2005, the University and Infirmary Health System, Inc. (the "Infirmary") entered into a lease agreement in which the University has agreed to lease certain land, buildings and equipment at its USA Knollwood Hospital campus to the Infirmary. The lease, which was effective April 1, 2006, extends fifty years, with an automatic forty-nine year renewal term. The portion of the lease applicable to the land and buildings is treated as an operating lease and the portion of the lease applicable to the equipment is treated as a capital lease. On April 1, 2006, the University received lease payments of $7,418,000, most of which is recorded as deferred revenue at September 30, 2006, and is receiving the majority of the remaining lease payments over a thirty year period.

(Continued)

Also during 2006, the University sold thirty-two lots in the Hillsdale area of campus to a third party, recognizing a gain on the disposal of approximately $350,000.

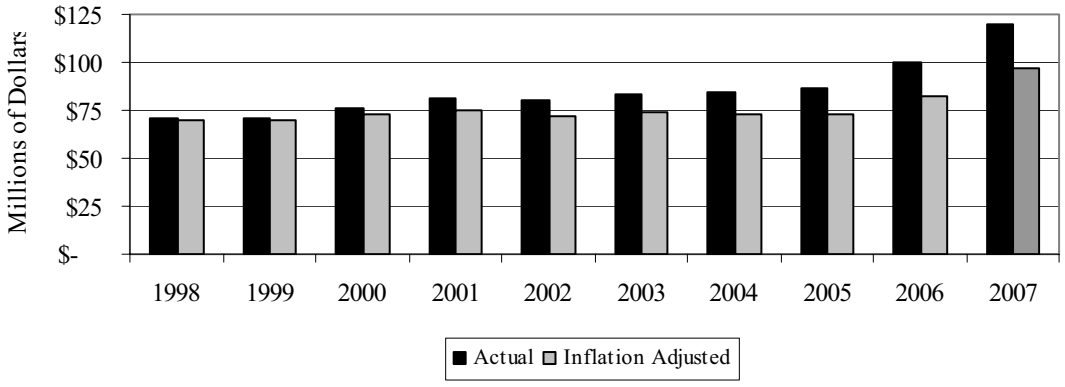
No significant new long-term debt was issued during 2006 and 2005. During 2004, the University issued its University Tuition Revenue Refunding and Capital Improvement Bonds, Series 2004, with a face value of $51,080,000. The proceeds from the issuance of the bonds, issued at a premium of approximately $2,300,000, were used to refund the Hospital and Auxiliary Revenue Refunding Bonds, Series 1993 ($21,790,000). Remaining amounts are being used to fund construction and other capital improvements at the University.

During the years ended September 30, 2006 and 2005, the University's bond credit rating was unchanged at Moody's A2. The University bond credit rating was upgraded in 2004.

Economic Outlook

While enrollment and tuition have both increased in recent years, state appropriations have historically been relatively flat. However, in 2006, the University experienced an increase of 17%, or approximately $14,581,000, in state appropriations. A similar increase has been approved and is expected for the 2007 budget year.

State Appropriations - Ten Year History



University administration is not aware of any other currently known facts, decisions, or conditions, except as noted below, that are expected to have a significant effect on the University's financial position or results of operations during fiscal year 2007 beyond those unknown variables having a global effect on virtually all types of business operations.

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Independent Auditors' Report on Basic Financial Statements and Schedule of Expenditures of Federal Awards

The Board of Trustees
University of South Alabama:

We have audited the accompanying basic financial statements of the University of South Alabama, a component unit of the State of Alabama, (the University) and its aggregate discretely presented component units as of and for the years ended September 30, 2006 and 2005, as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express opinions on these financial statements based on our audits. We did not audit the 2006 and 2005 consolidated financial statements of the University of South Alabama Foundation, which represents 91%, 100% and 44%, respectively, of the 2006 assets, net assets and revenues of the aggregate discretely presented component units and 91%, 100% and 22%, respectively, of the 2005 assets, net assets and revenues of the aggregate discretely presented component units. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the University of South Alabama Foundation, is based on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. The financial statements of the University of South Alabama Foundation, the University of South Alabama Health Services Foundation and the Professional and General Liability Trust Funds were not audited in accordance with *Government Auditing Standards.* An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinions.

As discussed in note 1, the financial statements of the University are intended to present the financial position, changes in financial position and, where applicable, cash flows of only that portion of the basic financial statements and the aggregate discretely presented component units of the State of Alabama that is attributable to the transactions of the University. They do not purport to, and do not, present fairly the financial position of the State of Alabama as of September 30, 2006 and 2005, the changes in its financial position, or, where applicable, its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

In our opinion, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the University and of its aggregate discretely presented component units as of September 30, 2006 and 2005, and the respective changes in financial position and cash flows, where applicable, thereof for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards,* we have also issued our report dated November 10, 2006, on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 1 through 10 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming opinions on the financial statements that collectively comprise the University's basic financial statements. The accompanying Schedule of Expenditures of Federal Awards for the year ended September 30, 2006 is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.* The schedule of Expenditures of Federal Awards has been subjected to the auditing procedures applied in the audit of the 2006 basic financial statements and, in our opinion, is fairly stated in the all material respects in relation to the 2006 basic financial statements taken as a whole.

KPMG LLP

November 10, 2006

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Statements of Net Assets

September 30, 2006 and 2005

(In thousands)

	2006	2005
Assets:		
Current assets:		
Cash and cash equivalents	$ 35,560	33,818
Investments	128,055	74,490
Net patient accounts receivable, (net of allowance for doubtful accounts of $47,866 and $48,922)	26,399	31,245
Accounts receivable, affiliates	8,822	9,451
Accounts receivable, other	17,969	13,644
Notes receivable, net	735	385
Prepaid expenses, inventories, and other	6,373	6,325
Total current assets	223,913	169,358
Noncurrent assets:		
Restricted cash and cash equivalents	2,600	8,272
Restricted investments	50,112	49,371
Investments	1,756	18,204
Accounts receivable	8,316	—
Notes receivable, net	5,854	3,935
Other noncurrent assets	5,724	5,819
Capital assets, net	247,875	231,027
Total noncurrent assets	322,237	316,628
Total assets	546,150	485,986
Liabilities:		
Current liabilities:		
Accounts payable and accrued liabilities	42,087	47,382
Deferred revenue	21,395	18,230
Deposits	600	964
Current portion of long-term debt	6,989	6,258
Total current liabilities	71,071	72,834
Noncurrent liabilities:		
Long-term debt, less current portion	115,481	120,875
Other long-term liabilities	48,240	36,321
Total noncurrent liabilities	163,721	157,196
Total liabilities	234,792	230,030
Net assets:		
Invested in capital assets, net of related debt	137,642	127,805
Restricted, nonexpendable:		
Scholarships	4,712	4,847
Other	7,900	7,361
Restricted, expendable:		
Scholarships	3,625	2,785
Other	22,341	7,212
Unrestricted	135,138	105,946
Total net assets	$ 311,358	255,956

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statements of Financial Position

June 30, 2006 and 2005

(In thousands)

Assets		**2006**	**2005**
Cash and cash equivalents	$	1,967	1,920
Investments:			
Securities, at fair value		121,762	118,405
Timber and mineral properties		148,863	141,954
Real estate		18,405	17,256
Accounts receivable		91	420
Other assets		286	282
Total assets	$	291,374	280,237
Liabilities and Net Assets			
Liabilities:			
Accounts payable	$	98	221
Contributions payable to the University of South Alabama		11	14
Notes payable		—	13,525
Other liabilities		763	776
Total liabilities		872	14,536
Net assets:			
Unrestricted		77,205	58,266
Temporarily restricted		48,879	43,089
Permanently restricted		164,418	164,346
Total net assets		290,502	265,701
Total liabilities and net assets	$	291,374	280,237

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA
HEALTH SERVICES FOUNDATION
(Discretely Presented Component Unit)

Statements of Financial Position

September 30, 2006 and 2005

(In thousands)

Assets		2006	2005
Current assets:			
Cash and cash equivalents	$	957	243
Investments		—	1,099
Patient accounts receivable (net of allowance for uncollectible accounts of approximately $5,844 and $5,038)		9,519	10,465
Other current assets		1,274	1,196
Total current assets		11,750	13,003
Assets limited as to use, held by trustee		15,145	12,165
Property and equipment, net		1,904	1,287
Total assets	$	28,799	26,455
Liabilities and Net Assets			
Current liabilities:			
Accounts payable	$	1,550	1,298
Accrued payroll		87	178
Current portion of notes payable		865	838
Current portion of obligation under capital lease		47	52
Due to affiliates		8,512	9,223
Total current liabilities		11,061	11,589
Notes payable, less current portion		1,505	2,370
Obligation under capital lease, less current portion		—	47
Estimated professional liability costs		15,145	12,165
Total liabilities		27,711	26,171
Unrestricted net assets		1,088	284
Total liabilities and net assets	$	28,799	26,455

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Statements of Revenues, Expenses, and Changes in Net Assets

Years ended September 30, 2006 and 2005

(In thousands)

	2006	2005
Operating revenues:		
Tuition and fees (net of scholarship allowances of $12,991 and $12,971)	$ 47,236	43,737
Net patient service revenue (net of provision for bad debts of $75,138 and $74,529)	201,373	201,413
Federal grants and contracts	29,608	31,110
State grants and contracts	6,653	6,614
Private grants and contracts	41,956	30,923
Auxiliary enterprises (net of scholarship allowances of $402 and $363)	16,586	14,891
Other operating revenues	30,947	31,024
Total operating revenues	374,359	359,712
Operating expenses:		
Salaries and benefits	317,626	307,039
Supplies and other services	109,653	105,116
Scholarships and fellowships	4,083	3,934
Utilities	12,793	9,837
Depreciation	18,460	18,661
Total operating expenses	462,615	444,587
Operating loss	(88,256)	(84,875)
Nonoperating revenues (expenses):		
State appropriations	101,203	86,622
Investment income	9,418	7,121
Interest expense	(4,943)	(5,750)
Other nonoperating revenues	30,263	9,238
Other nonoperating expenses	(2,070)	(207)
Net nonoperating revenues	133,871	97,024
Income before capital contributions and additions to endowment	45,615	12,149
Capital appropriations	—	50
Capital contributions and grants	8,747	8,783
Additions to endowment	1,040	864
Increase in net assets	55,402	21,846
Net assets:		
Beginning of year	255,956	234,110
End of year	$ 311,358	255,956

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statement of Activities and Changes in Net Assets

Year ended June 30, 2006

(In thousands)

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Revenues, gains, and other support:				
Net realized and unrealized gains (losses) on investments	$ 29,593	4,998	(642)	33,949
Rents, royalties and timber sales	15,952	—	120	16,072
Interest and dividends	2,188	352	3	2,543
Gifts	—	259	339	598
Required match of donor contributions	(252)	—	252	—
Interfund interest	(4,869)	4,869	—	—
Net assets released from program restrictions	4,688	(4,688)	—	—
Total revenues, gains, and other support	47,300	5,790	72	53,162
Expenditures:				
Program services:				
Faculty support	2,550	—	—	2,550
Scholarships	1,032	—	—	1,032
Other	2,492	—	—	2,492
Total program service expenditures	6,074	—	—	6,074
Management and general	2,161	—	—	2,161
Other investment expense	1,368	—	—	1,368
Interest expense	449	—	—	449
Depreciation and depletion expense	18,309	—	—	18,309
Total expenditures	28,361	—	—	28,361
Increase in net assets	18,939	5,790	72	24,801
Net assets – beginning of year	58,266	43,089	164,346	265,701
Net assets – end of year	$ 77,205	48,879	164,418	290,502

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA FOUNDATION
(Discretely Presented Component Unit)

Consolidated Statement of Activities and Changes in Net Assets

Year ended June 30, 2005

(In thousands)

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Revenues, gains, and other support:				
Net realized and unrealized gains (losses) on investments	$ 9,292	(1,266)	40	8,066
Rents, royalties and timber sales	5,109	—	97	5,206
Interest and dividends	1,724	984	9	2,717
Gifts	2	149	55	206
Required match of donor contributions	(54)	—	54	—
Interfund interest	(3,645)	3,645	—	—
Net assets released from program restrictions	5,055	(5,055)	—	—
Total revenues, gains, and other support	17,483	(1,543)	255	16,195
Expenditures:				
Program services:				
Faculty support	2,631	—	—	2,631
Scholarships	1,019	—	—	1,019
Other	2,563	—	—	2,563
Total program service expenditures	6,213	—	—	6,213
Management and general	2,148	—	—	2,148
Other investment expense	1,300	—	—	1,300
Interest expense	907	—	—	907
Depreciation and depletion expense	5,529	—	—	5,529
Total expenditures	16,097	—	—	16,097
Increase (decrease) in net assets	1,386	(1,543)	255	98
Net assets – beginning of year	56,880	44,632	164,091	265,603
Net assets – end of year	$ 58,266	43,089	164,346	265,701

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA
HEALTH SERVICES FOUNDATION
(Discretely Presented Component Unit)

Statements of Operations and Changes in Net Assets (Deficit)

Years ended September 30, 2006 and 2005

(In thousands)

	2006	2005
Unrestricted revenues, gains and other support:		
Net patient service revenue	$ 61,337	51,680
Other revenue	6,971	6,688
Total unrestricted revenues, gains and other support	68,308	58,368
Expenses:		
Salaries and benefits	38,923	33,918
General and administrative	14,194	13,418
Provision for uncollectible accounts	10,999	10,377
Depreciation and amortization	716	621
Interest	168	157
Total expenses	65,000	58,491
Operating gain (loss)	3,308	(123)
Nonoperating gains	298	276
Revenues over expenses	3,606	153
Contributions restricted for debt service, received and expended within the same year	1,000	1,000
Transfer of capital to University of South Alabama College of Medicine	(3,800)	—
Unrealized loss on other-than-trading securities	(2)	(19)
Change in unrestricted net assets	804	1,134
Unrestricted net assets (deficit) at beginning of year	284	(850)
Unrestricted net assets at end of year	$ 1,088	284

See accompanying notes to financial statements.

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Statements of Cash Flows

Years ended September 30, 2006 and 2005

(In thousands)

	2006	2005
Cash flows from operating activities:		
Receipts related to tuition and fees	$ 48,152	44,083
Receipts from and on behalf of patients and third-party payers	205,864	197,650
Receipts from grants and contracts	80,765	66,912
Receipts related to auxiliary enterprises	17,265	14,860
Payments to suppliers and vendors	(120,044)	(103,923)
Payments to employees and related benefits	(322,698)	(309,840)
Payments for scholarships and fellowships	(4,120)	(3,934)
New loans issued to students	(1,381)	(1,162)
Student loan repayments	1,055	1,721
Other operating receipts	36,808	31,308
Net cash used in operating activities	(58,334)	(62,325)
Cash flows from noncapital financing activities:		
State appropriations	101,217	86,619
Endowment gifts	981	804
Agency funds received	654	761
Agency funds disbursed	(467)	(729)
Stafford and PLUS loans received	63,079	58,966
Stafford and PLUS loans disbursed	(63,485)	(58,768)
Other nonoperating revenues	18,481	8,651
Other nonoperating expenses	(2,009)	(127)
Net cash provided by noncapital financing activities	118,451	96,177
Cash flows from capital and related financing activities:		
Capital appropriations	—	50
Capital gifts and grants	8,747	8,639
Purchases of capital assets	(33,972)	(34,445)
Proceeds from sale of capital assets	1,125	423
Proceeds from issuance of capital debt	284	—
Principal payments on capital debt	(5,907)	(5,922)
Interest payments on capital debt	(5,844)	(4,481)
Net cash used in capital and related financing activities	(35,567)	(35,736)
Cash flows from investing activities:		
Interest and dividends on investments	8,450	4,538
Purchases of investments	(226,628)	(236,497)
Proceeds from sales of investments	189,698	225,437
Net cash used in investing activities	(28,480)	(6,522)
Net decrease in cash and cash equivalents	(3,930)	(8,406)
Cash and cash equivalents (unrestricted and restricted):		
Beginning of year	42,090	50,496
End of year	$ 38,160	42,090

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Statements of Cash Flows

Years ended September 30, 2006 and 2005

(In thousands)

		2006	2005
Reconciliation of operating loss to net cash used in operating activities:			
Operating loss	$	(88,256)	(84,875)
Adjustments to reconcile operating loss to net cash used in operating activities:			
Depreciation expense		18,460	18,661
Changes in assets and liabilities, net:			
Student receivables		253	(459)
Net patient accounts receivable		4,846	(2,095)
Grants and contracts receivables		284	(1,329)
Student loan program receivables		(511)	559
Other receivables		(586)	(2,983)
Prepaid expenses, inventories, and other		1,647	(597)
Accounts payable and accrued liabilities		(3,878)	9,762
Deferred revenue		9,407	1,031
Net cash used in operating activities	$	(58,334)	(62,325)
Noncash investing, noncapital financing, and capital and related financing transactions:			
Increase in fair value of investments recognized as a component of investment income	$	2,485	1,430
Additional maturity on capital appreciation bonds payable recorded as interest expense		1,398	1,330
Promissory note issued in exchange for land		2,927	—
Gifts of capital assets		59	—
Pledges of operating and capital gifts		11,235	—
Capitalization of construction period interest		915	197

See accompanying notes to financial statements.

(1) Summary of Significant Accounting Policies

(a) Reporting Entity

The accompanying basic financial statements present the financial position and activities of the University of South Alabama (the University), which is a component unit of the State of Alabama. The financial statements of the University are intended to present the financial position, changes in financial position and, where applicable, cash flows of only that portion of the basic financial statements and the aggregate discretely presented component units of the State of Alabama that is attributable to the transactions of the University.

The financial reporting entity, as defined by Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity* and amended by GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units,* consists of the primary government and all of its component units. Component units are legally separate organizations for which the primary government is financially accountable and other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the financial statements to be misleading or incomplete. Accordingly, the basic financial statements include the accounts of the University, as the primary government, and the accounts of the following entities as component units.

The University has adopted GASB Statement No. 39 which provides criteria for determining whether certain organizations should be reported as component units based on the nature and significance of their relationship with the primary government. The statement also clarifies reporting requirements for those organizations. Based on these criteria, the University reports the University of South Alabama Foundation (USA Foundation) and the University of South Alabama Health Services Foundation (USAHSF) as discretely presented component units.

The University is also affiliated with the South Alabama Medical Science Foundation and USA Research and Technology Corporation. These entities are not considered component units of the University under the provisions of GASB Statement Nos. 14 and 39 (see note 13 for further discussion of these entities).

(b) Professional Liability and General Liability Trust Funds

GASB Statement No. 14 requires the University, as the primary government, to include in its financial statements, as a component unit, organizations that, even though they are legally separate entities, meet certain requirements as defined by GASB Statement No. 14. The medical malpractice liability of the University is maintained and managed in a separate professional liability trust fund (the PLTF) in which the University and USAHSF are the only participants. In accordance with the bylaws of the trust fund, the president of the University is responsible for appointing members of the trust fund policy committee. Additionally, the general liability of the University is maintained and managed in a general liability trust fund (the GLTF) for which the University, as defined by GASB Statement No. 14, is responsible. The PLTF and GLTF are separate legal entities which are governed by the University Board of Trustees through the University president. As such, PLTF and GLTF are reported as blended component units.

(c) University of South Alabama Foundation

The USA Foundation is a not-for-profit foundation that was organized for the purpose of promoting education, scientific research and charitable purposes, and to assist in developing and advancing the University in furthering, improving and expanding its properties, services, facilities, and activities. Because of the significance of the relationship between the University and the USA Foundation, the USA Foundation is considered a component unit of the University. The Board of Directors of the USA Foundation is not appointed or controlled by the University. The University receives distributions from the USA Foundation primarily for scholarship, faculty and other support. Total distributions received or accrued by the University for the years ended September 30, 2006 and 2005 were $5,996,000 and $6,143,000, respectively, and are primarily included in other nonoperating revenues and capital contributions and grants in the University's statements of revenues, expenses, and changes in net assets. The USA Foundation presents its financial statements in accordance with standards issued by the Financial Accounting Standards Board (FASB). The USA Foundation is reported in separate financial statements because of the difference in the financial reporting format for the USA Foundation. The USA Foundation has a June 30 fiscal year end which differs from the University's September 30 fiscal year end. In accordance with GASB Statement No. 14, this discretely presented unit has been included with the most recent fiscal year. The consolidated statements of financial position and the consolidated statements of activities and changes in net assets for the USA Foundation as of and for the years ended June 30, 2006 and 2005 are discretely presented following the statements of net assets and statements of revenues, expenses, and changes in net assets of the University.

(d) University of South Alabama Health Services Foundation

The USAHSF is a not-for-profit corporation that exists to provide a group medical practice for physicians who are faculty members of the University and to further medical education and research at the University. Because of the significance of the relationship between the University and USAHSF, USAHSF is considered a component unit of the University. The USAHSF reimburses the University for salaries, certain administrative expenses, Dean's clinical assessment and other support services. Total amounts received and accrued for such expenses were approximately $37,709,000 and $28,959,000 for the years ended September 30, 2006 and 2005, respectively, and are reflected as private grants and contracts in the accompanying statements of revenues, expenses, and changes in net assets of the University. The USAHSF presents its financial statements in accordance with standards issued by the FASB. The statements of financial position and the statements of operations and changes in unrestricted net assets (deficit) for the USAHSF for the years ended September 30, 2006 and 2005 are discretely presented following the statements of net assets and statements of revenues, expenses, and changes in net assets of the University.

(e) Measurement Focus and Basis of Accounting

For financial reporting purposes, the University is considered a special purpose governmental agency engaged only in business type activities, as defined by GASB Statement No. 34. Accordingly, the University's basic financial statements have been presented using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned, and expenses are recorded when an obligation has been incurred.

The University prepares its basic financial statements in accordance with U. S. generally accepted accounting principles, as prescribed by GASB, including all applicable effective statements of the GASB and all statements of the FASB issued through November 30, 1989 that do not conflict with GASB pronouncements. The University has elected not to apply the provisions of any pronouncements of the FASB issued after November 30, 1989.

(f) Use of Estimates

The preparation of financial statements in conformity with U. S. generally accepted accounting principles requires that management make estimates and assumptions affecting the reported amounts of assets and liabilities, revenues and expenses, as well as disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

In particular, laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates related to these programs could change by a material amount in the near term.

(g) Cash and Cash Equivalents

Cash and cash equivalents are defined as petty cash, demand accounts and any short-term investments that take on the character of cash. These investments generally, but not always, have maturities of less than three months and include repurchase agreements and money market accounts.

(h) Investments and Investment Income

Investments are recorded at fair value. Investments received by gift are recorded at fair value at the date of receipt. Changes in the fair value of investments are reported in investment income.

(i) Accounts Receivable

Accounts receivable primarily result from net patient service revenue. Accounts receivable from affiliates primarily represent amounts due from USAHSF for salaries, and certain administrative and other support services. Accounts receivable – other includes amounts due from students, the federal government, state and local governments, or private sources in connection with reimbursement of allowable expenditures made pursuant to the University's grants and contracts. Accounts receivable are recorded net of estimated uncollectible amounts.

(j) Inventories

The University's inventories primarily consist of bookstore inventories and medical supplies and pharmaceuticals. Bookstore inventories are valued at the lower of cost (moving average basis) or market. Medical supplies and pharmaceuticals are stated at the lower of cost (first-in, first-out method) or market.

(k) Capital Assets

Capital assets are recorded at cost, if purchased, or at fair value at date of donation. Depreciation is provided over the useful life of each class of depreciable asset using the straight-line method. Major renewals and renovations are capitalized. Costs for repairs and maintenance are expensed when incurred. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and the gain or loss, if any, is included in nonoperating revenues (expenses) in the statements of revenues, expenses, and changes in net assets.

All capital assets other than land are depreciated using the following asset lives:

Buildings, infrastructure and certain building components	40 to 100 years
Fixed equipment	10 to 20 years
Land improvements	8 to 20 years
Library materials	10 years
Other equipment	4 to 15 years

Certain buildings are componentized for depreciation purposes.

Interest costs for certain assets constructed are capitalized as a component of the cost of acquiring those assets.

During the year ended September 30, 2006, the University adopted GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. The implementation of this standard did not have a material impact on the University's basic financial statements.

(l) Deferred Revenue

Student tuition, fees, and dormitory rentals are deferred and recognized over the applicable portion of each school term.

Operating lease rental payments related to the University's lease of USA Knollwood Hospital to the Infirmary Health System, Inc. (see note 10) are deferred and recognized as revenue over the term of the lease using the straight-line method.

(m) Classification of Net Assets

The University's net assets are classified as follows:

Invested in capital assets, net of related debt represents the University's total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such debt is excluded from the calculation of *invested in capital assets, net of related debt.*

Restricted, nonexpendable net assets consist of endowment and similar type funds which donors or other outside sources have stipulated, as a condition of the gift instrument, the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may either be expended or added to principal.

Restricted, expendable net assets include resources that the University is legally or contractually obligated to spend in accordance with restrictions imposed by external parties.

Unrestricted net assets represent resources derived from student tuition and fees, state appropriations, net patient service revenue, sales and services of educational activities and auxiliary enterprises. Auxiliary enterprises are substantially self-supporting activities that provide services for students, faculty, and staff. While unrestricted net assets may be designated for specific purposes by action of management or the Board of Trustees, they are available for use at the discretion of the governing board, to meet current expenses for any purpose. Substantially all unrestricted net assets are designated for academic and research programs and initiatives, and capital programs.

When an expense is incurred that can be paid using either restricted or unrestricted resources, the University addresses each situation on a case-by-case basis prior to determining the resources to be used to satisfy the obligation.

(n) Scholarship Allowances and Student Financial Aid

Student tuition and fees, and certain other revenues from students, are reported net of scholarship discounts and allowances in the statements of revenues, expenses, and changes in net assets. Scholarship discounts and allowances are the difference between the stated charge for goods and services provided by the University and the amount that is paid by students and/or third parties making payments on the students' behalf. Certain governmental grants, such as Pell grants and other federal, state, or nongovernmental programs are recorded as either operating or nonoperating revenues in the University's basic financial statements based on their classification as either an exchange or nonexchange transaction. To the extent that revenues from such programs are used to satisfy tuition and fees and certain other student charges, the University has recorded a scholarship discount and allowance.

(o) Donor Restricted Endowments

The University is subject to the "Uniform Management of Institutional Funds Act (UMIFA)" of the Code of Alabama. This law allows the University, unless otherwise restricted by the donor, to spend net appreciation, realized and unrealized, on the endowment. The University's endowment spending policy provides that 5% of the three-year invested net asset moving average value (inclusive of net realized and unrealized gains and losses), as measured at September 30, is available annually for spending. The University's policy is to retain the endowment net interest and dividend income and net realized and unrealized appreciation with the endowment after distributions allowed by the spending policy have been made. These amounts, unless otherwise directed by the donor, are included in restricted, expendable net assets.

(p) Classification of Revenues

The University has classified its revenues as either operating or nonoperating revenues.

Operating revenues include activities that have the characteristics of exchange transactions such as student tuition and fees, net of scholarship discounts and allowances; sales and services of auxiliary enterprises, net of scholarship allowances; most federal, state, and local grants and contracts; and, net patient service revenue.

Nonoperating revenues include activities that have the characteristics of nonexchange transactions, such as gifts and contributions, and other revenue sources such as state appropriations, investment income, and gifts.

(q) Gifts and Pledges

Pledges of financial support from organizations and individuals representing an unconditional promise to give are recognized in the basic financial statements once all eligibility requirements, including time requirements, have been met. In the absence of such a promise, revenue is recognized when the gift is received. Endowment pledges generally do not meet eligibility requirements, as defined by GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions* and are not recorded as assets until the related gift has been received. Unconditional promises that are expected to be collected in future years are recorded at the present value of the estimated future cash flows.

(r) Grants and Contracts

The University has been awarded grants and contracts for which funds have not been received or expenditures made for the purpose specified in the award. These awards have not been reflected in the basic financial statements, but represent commitments of sponsors to provide funds for specific research or training projects. For grants that have allowable cost provisions, the revenue will be recognized as the related expenditures are made. For grants with work completion requirements, the revenue is recognized as the work is completed. For grants without either of the above requirements, the revenue is recognized as it is received.

(s) Net Patient Service Revenue

Net patient service revenue is reported at estimated net realizable amounts due from patients, third-party payers and others for healthcare services rendered, including estimated retroactive revenue adjustments due to future audits, reviews and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered and such amounts are adjusted in future periods, as adjustments become known or as years are no longer subject to such audits, reviews and investigations.

(t) Costs of Borrowing

Debt financing costs and bond premium and discounts are deferred and amortized using the straight-line method, which approximates the effective interest rate method, over the term of the related bond issue.

(u) Compensated Absences

The University accrues annual leave for employees as incurred at rates based upon length of service and job classification.

(v) Reclassifications

Certain amounts in the 2005 basic financial statements have been reclassified in order to conform to the 2006 classification.

(2) Income Taxes

The University is classified as both a governmental entity under the laws of the State of Alabama and as a tax-exempt entity under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(3). Consistent with that designation, no provision for income taxes has been made in the accompanying basic financial statements.

(3) Cash

Pursuant to the Security for Alabama Funds Enhancement Act, funds on deposit may be placed in an institution designated as a qualified public depository (QPD) by the State of Alabama. QPD institutions pledge securities to a statewide collateral pool administered by the State Treasurer's office. Such financial institutions contribute to this collateral pool in amounts proportionate to the total amount of public fund deposits at their respective institutions. The securities are held at the Federal Reserve Bank and are designated for the State of Alabama. Additional collateral was not required for University funds on deposit with QPD institutions. At September 30, 2006, the net public deposits subject to collateral requirements for all institutions participating in the pool totaled approximately $6,451,755,000. The University had cash and cash equivalents totaling $38,160,000 and $42,090,000 at September 30, 2006 and 2005, respectively.

(4) Investments

(a) University of South Alabama

The investments of the University are invested pursuant to the University of South Alabama "Nonendowment Cash Pool Investment Policies" and the "Endowment Fund Investment Policy" (collectively referred to as the University Investment Policies) as adopted by the Board of Trustees. The purpose of the nonendowment cash pool investment policy is to provide guidelines by which pooled funds not otherwise needed to meet daily operational cash flows can be invested to earn a maximum return, yet still maintain sufficient liquidity to meet fluctuations in the inflows and outflows of University operational funds. Further, endowment fund investment policies exist to provide earnings to fund specific projects of the endowment fund, while preserving principal. The University Investment Policies require that management apply the "prudent person" standard in the context of managing its investment portfolio.

(Continued)

The investments of the blended component units of the University are invested pursuant to the separate investment policy of the PLTF and GLTF (the Trust Fund Investment Policy.) The objectives of the Trust Fund Investment Policy are to provide a source of funds to pay general and professional liability claims and to achieve long-term capital growth to help defray future funding requirements. Additionally, investments of the University's component units both blended and discretely presented are subject to UMIFA as well as any requirements placed on them by contract or donor agreements.

Certain investments, primarily related to the University's endowment assets, are pooled. The University uses this pool to manage its investments and distribute investment income to individual endowment funds.

Investments of the University, by type, at fair value, are as follows at September 30, 2006 and 2005 (in thousands).

		2006	2005
U.S. Treasury notes	$	12,274	10,686
U.S. Federal agency notes		42,232	78,708
Commercial paper		92,600	23,654
Pooled equity mutual funds		23,964	20,038
Pooled debt mutual funds		2,116	2,143
Managed income alternative investments		6,318	5,744
Collateralized mortgage obligations		—	701
Other		419	391
	$	179,923	142,065

At September 30, 2006 and 2005, $2,957,000 and $1,828,000, respectively, of appreciation in fair value of investments of donor-restricted endowments was recognized and are included in restricted expendable net assets in the accompanying statements of net assets.

Credit Risk and Concentration of Credit Risk

The University Investment Policies limit investment in corporate bonds to securities with a minimum "A" rating, at the time of purchase, by both Moody's and Standard and Poor's. Investments in corporate paper are limited to issuers with a minimum quality rating of P-1 by Moody's, A-1 by Standard and Poor's or F-1 by Fitch.

Additionally, the University Investment Policies require that not more than 10% of the cash, cash equivalents and investments of the University be invested in the obligations of a single private corporation and not more than 35% of the cash, cash equivalents and investments of the University be invested in the obligations of a single government agency.

(Continued)

The University's exposure to credit risk and concentration of credit risk at September 30, 2006 is as follows:

	Credit rating	% of total investments
Federal Home Loan Mortgage Corporation	AAA	13.9%
Citigroup Funding, Inc.	A1+	12.7%
G. E. Capital Corporation	A-1	8.8%
LaSalle Bank Corporation	A1+	6.7%
Bear Stearns Company, Inc	A1+	6.0%
American Express Credit Corporation	A1+	6.0%
Federal National Mortgage Association	AAA	6.0%
AIG Funding Corporation	A1+	5.5%
Societe Generale	A1+	5.4%
Federal Home Loan Bank Corporation	AAA	3.4%
Common - Bond Fund	AA	1.2%
Federal Farm Credit Banks Funding Corporatioin	AAA	0.2%
Government National Mortgage Association	AAA	0.1%

The University's exposure to credit risk and concentration of credit risk at September 30, 2005 is as follows:

	Credit rating	% of total investments
Federal National Mortgage Association	AAA	24.7%
Federal Home Loan Mortgage Corporation	AAA	22.8%
G. E. Capital Corporation	A-1	9.0%
Federal Home Loan Bank Corporation	AAA	4.8%
Citigroup Funding, Inc.	A1+	4.2%
Toyota Motor Credit Corporation	A1+	3.5%
Federal Farm Credit Banks Funding Corporatioin	AAA	3.3%
Common - Bond Fund	AA	1.5%
Government National Mortgage Association	AAA	0.3%

(Continued)

Interest Rate Risk

At September 30, 2006, the maturity dates of the University's debt investments were as follows (in thousands):

	Fair value	Years to maturity			
		Less than 1	1-5	6-10	More than 10
U.S. Treasury notes	$ 12,274	4,767	7,507	—	—
U.S. Federal agency notes	42,232	28,218	13,186	731	97
Commercial paper	92,600	91,613	987	—	—
Pooled debt mutual funds	2,116	—	2,116	—	—
	$ 149,222	124,598	23,796	731	97

At September 30, 2005, the maturity dates of the University's debt investments were as follows (in thousands):

	Fair value	Years to maturity			
		Less than 1	1-5	6-10	More than 10
U.S. Treasury notes	$ 10,686	4,606	6,080	—	—
U.S. Federal agency notes	78,708	67,567	10,800	244	97
Collateralized mortgage obligations	701	—	9	—	692
Commercial paper	23,654	23,654	—	—	—
Pooled debt mutual funds	2,143	—	2,143	—	—
	$ 115,892	95,827	19,032	244	789

Because the debt mutual funds had a weighted average maturity of 5.2 and 4.4 years at September 30, 2006 and 2005, respectively, the investments were presented in the 1-5 year maturity category.

The University's Investment Policies do not specifically address the length to maturity on investments which the University must follow; however, they do require that the maturity range of investments be consistent with the liquidity requirements of the University.

Mortgage-Backed Securities

The University, from time to time, invests in mortgage-backed securities issued by the Government National Mortgage Association (GNMA) and the Federal National Mortgage Association (FNMA), agencies of the United States government. The University invests in these securities to increase the yield and return on its investment portfolio given the available alternative investment opportunities.

The fair value of mortgage-backed securities is generally based on the cash flows from principal and interest receipts on the underlying mortgage pools. These securities include collateralized mortgage obligations (CMOs). In CMOs, the cash flow from principal and interest payments from one or more

(Continued)

mortgage pass-through securities or a pool of mortgages may be reallocated to multiple security classes with different priority claims and payment streams (commonly referred to as tranches). A holder of the CMO security thus chooses the class of security that best meets its risk and return objectives. CMOs are subject to significant market risk due to fluctuations in interest rates, prepayment rates and various liquidity factors related to their specific markets. There are no CMOs in the University's investment portfolio at September 30, 2006.

(b) University of South Alabama Foundation

Investments in securities consist primarily of marketable equity securities totaling $121,762,000 and $118,405,000, at June 30, 2006 and 2005, respectively.

Investment income was comprised of the following for the years ended June 30, 2006 and 2005 (in thousands):

	2006	2005
Unrealized gains	$ 32,437	853
Realized gains	1,512	7,213
Timber sales	15,330	4,533
Interest and dividends	2,543	2,717
Rents	462	494
Royalties	280	179
	$ 52,564	15,989

Investment related expenses in the amount of $335,000 and $358,000, respectively, are included in the USA Foundation's management and general expenses in the accompanying 2006 and 2005 consolidated statements of activities and changes in net assets.

Real estate at June 30, 2006 and 2005 consisted of the following property held (in thousands):

	2006	2005
Land and land improvements – held for investment	$ 16,429	15,035
Building and building improvements – held for investment	5,072	5,072
	21,501	20,107
Less accumulated depreciation	3,096	2,851
	$ 18,405	17,256

Depreciation expense on real estate available for rent and occupied was $245,000 in both 2006 and 2005, respectively.

Timber and mineral properties are stated at fair market value. Depletion of mineral properties is recognized over the remaining producing lives of the properties based on total estimated production

and current period production. Depletion of timber properties is recognized on a specific identification basis as timber rights are sold or on a unit basis for sales made on that basis. Reforestation costs consisting of site preparation and planting of seedlings are capitalized.

(5) Capital Assets

A summary of the University's capital asset activity for the year ended September 30, 2006 follows (in thousands):

	Beginning balance	Additions	Transfers	Reductions	Ending balance
Capital assets not being depreciated:					
Land	$ 23,886	3,746	895	(37)	28,490
Construction-in-progress	28,078	24,619	(6,907)	(119)	45,671
	51,964	28,365	(6,012)	(156)	74,161
Capital assets being depreciated:					
Land improvements	17,434	36	—	—	17,470
Buildings, fixed equipment, and infrastructure	285,604	1,838	5,029	(5,244)	287,227
Other equipment	96,066	4,626	983	(13,334)	88,341
Library materials	35,527	2,512	—	—	38,039
	434,631	9,012	6,012	(18,578)	431,077
Less accumulated depreciation for:					
Land improvements	(8,973)	(937)	—	—	(9,910)
Buildings, fixed equipment, and infrastructure	(154,524)	(7,518)	—	5,223	(156,819)
Other equipment	(66,075)	(8,333)	—	11,442	(62,966)
Library materials	(25,996)	(1,672)	—	—	(27,668)
	(255,568)	(18,460)	—	16,665	(257,363)
Capital assets being depreciated, net	179,063	(9,448)	6,012	(1,913)	173,714
Capital assets, net	$ 231,027	18,917	—	(2,069)	247,875

At September 30, 2006, the University had commitments of approximately $30,042,000 related to various construction projects.

(Continued)

A summary of the University's capital asset activity for the year ended September 30, 2005 follows (in thousands):

	Beginning balance	Additions	Transfers	Reductions	Ending balance
Capital assets not being depreciated:					
Land	$ 23,774	112	—	—	23,886
Construction-in-progress	11,919	22,865	(6,706)	—	28,078
	35,693	22,977	(6,706)	—	51,964
Capital assets being depreciated:					
Land improvements	13,163	—	4,271	—	17,434
Buildings, fixed equipment, and infrastructure	284,924	125	672	(117)	285,604
Other equipment	90,649	7,800	1,763	(4,146)	96,066
Library materials	33,346	2,181	—	—	35,527
	422,082	10,106	6,706	(4,263)	434,631
Less accumulated depreciation for:					
Land improvements	(8,069)	(904)	—	—	(8,973)
Buildings, fixed equipment, and infrastructure	(147,211)	(7,424)	—	111	(154,524)
Other equipment	(61,429)	(8,636)	—	3,990	(66,075)
Library materials	(24,299)	(1,697)	—	—	(25,996)
	(241,008)	(18,661)	—	4,101	(255,568)
Capital assets being depreciated, net	181,074	(8,555)	6,706	(162)	179,063
Capital assets, net	$ 216,767	14,422	—	(162)	231,027

At September 30, 2005, the University had commitments of approximately $14,364,000 related to various construction projects.

(Continued)

(6) Noncurrent Liabilities

A summary of the University's noncurrent liability activity for the years ended September 30, 2006 and 2005 follows (in thousands):

	2006					
	Beginning balance	Additions	Reductions	Ending balance	Less amounts due within one year	Noncurrent liabilities
Long-term debt:						
Note payable	$ 4,246	—	(1,375)	2,871	1,423	1,448
Bonds payable	122,887	1,397	(4,962)	119,322	5,476	113,846
Capital lease payable	—	284	(7)	277	90	187
Total long-term debt	127,133	1,681	(6,344)	122,470	6,989	115,481
Other long-term liabilities	51,224	26,029	(17,103)	60,150	11,910	48,240
Total noncurrent liabilities	$ 178,357	27,710	(23,447)	182,620	18,899	163,721

	2005					
	Beginning balance	Additions	Reductions	Ending balance	Less amounts due within one year	Noncurrent liabilities
Long-term debt:						
Note payable	$ 5,875	—	(1,629)	4,246	1,378	2,868
Bonds payable	125,934	1,330	(4,377)	122,887	4,880	118,007
Total long-term debt	131,809	1,330	(6,006)	127,133	6,258	120,875
Other long-term liabilities	47,434	16,320	(12,530)	51,224	14,903	36,321
Total noncurrent liabilities	$ 179,243	17,650	(18,536)	178,357	21,161	157,196

Other long-term liabilities primarily consist of self-insurance liabilities and liabilities related to compensated absences. Amounts due within one year are included in accounts payable and accrued liabilities.

(7) Note and Bonds Payable

(a) University of South Alabama

Note Payable

Note payable consisted of the following at September 30, 2006 and 2005 (in thousands):

	2006	2005
Compass Bank limited obligation note, 2.743% payable through September 2008, unsecured	$ 2,871	$ 4,246

(Continued)

Bonds Payable

Bonds payable consisted of the following at September 30, 2006 and 2005 (in thousands):

		2006	2005
University Tuition Revenue Refunding Bonds, Series 1996, 3.80% to 5.00%, payable through November 2015	$	24,825	26,750
University Tuition Revenue Bonds, Series 1999 Current Interest, 3.70% to 4.35%, payable through November 2010		15,230	17,005
University Tuition Revenue Bonds, Series 1999 Capital Appreciation, 4.70% to 5.25%, payable November 2011 through November 2018		28,809	27,411
University Tuition Revenue Refunding and Capital Improvement Bonds, Series 2004, 2.00% to 5.00%, payable through March 2024		48,754	49,935
		117,618	121,101
Plus unamortized premium		2,074	2,193
Less unamortized discount		(370)	(407)
	$	119,322	122,887

Substantially all student tuition and fee revenues secure University bonds. Series 1996 Bonds began maturing November 2000, and are redeemable beginning May 2006, at varying premiums. Series 1999 Current Interest Bonds began maturing November 2002, and Capital Appreciation Bonds mature beginning November 2011. Series 1999 Bonds are not redeemable prior to maturity. Series 2004 Bonds began maturing in March 2005 and are redeemable beginning in March 2014.

During the years ended September 30, 2006 and 2005, the maturity value of the Capital Appreciation Bonds increased $1,398,000 and $1,330,000, respectively, over the original principal amount of $19,810,000, reflecting accretion of interest.

Approximately $12,362,000 and $21,764,000 of proceeds from the issuance of the Series 2004 Bonds remained unspent at September 30, 2006 and 2005, respectively. These amounts are included in restricted cash and cash equivalents ($1,510,000 in 2006 and $4,003,000 in 2005) and restricted investments ($10,852,000 in 2006 and $17,761,000 in 2005) on the statements of net assets and are restricted for capital purposes as outlined in the indenture.

The University defeased certain indebtedness during 1978 and 1984 by depositing funds in escrow trust accounts sufficient to provide for the subsequent payment of principal and interest on the defeased indebtedness. Neither the assets of the escrow trust accounts nor the defeased indebtedness

(Continued)

is included in the accompanying statements of net assets. The principal outstanding on all defeased issues was $9,040,000 at September 30, 2006.

The University is subject to restrictive covenants related to certain note and bonds payable. At September 30, 2006, management believes the University was in compliance with such financial covenants.

Debt Service on Long-Term Obligations

Total debt service by fiscal year is as follows (in thousands):

	Debt service on bonds			Debt service on note		
	Principal	Interest	Additional maturity	Principal	Interest	Total
2007	$ 5,476	5,606	(1,469)	1,423	61	11,097
2008	5,749	5,438	(1,544)	1,448	21	11,112
2009	6,595	5,238	(1,622)	—	—	10,211
2010	7,315	5,005	(1,705)	—	—	10,615
2011	7,050	4,763	(1,792)	—	—	10,021
2012-2016	38,989	19,153	(7,091)	—	—	51,051
2017-2021	38,765	10,269	(1,258)	—	—	47,776
2022-2025	24,160	1,852	—	—	—	26,012
Subtotal	134,099	57,324	(16,481)	2,871	82	177,895
Plus (less):						
Additional maturity	(16,481)					
Unamortized bond premium	2,074					
Unamortized bond discount	(370)					
Total	$ 119,322					

The principal amount of debt service due on bonds at September 30, 2006 includes $16,481,000 representing additional maturity value on Series 1999 Capital Appreciation Bonds. These bonds mature in years 2011 through 2019 and are noninterest bearing. Although this additional maturity is presented as principal on the debt service schedule above, it is also recognized as interest expense on an annual basis in the University's financial statements as it accretes.

(b) University of South Alabama Foundation

The USA Foundation financed the purchase of timber property through issuance of a variable rate note payable to Regions Bank. The outstanding balance at June 30, 2006 and 2005 is $0 and $12,900,000, respectively.

The variable rate note was secured by timberland with a carrying value of $97,858,000 at June 30, 2005 and contract rights for the sale of timber. The variable rate note had an interest rate at the London InterBank Offered Rate plus 0.75%, which was 4.09% at June 30, 2005. Interest expense was approximately $401,000 and $470,000 for the years ended June 30, 2006 and 2005, respectively.

On October 16, 2001, the USA Foundation entered into a five-year agreement with Regions Financial Corporation (the Counterparty), whereby the USA Foundation agreed to pay a fixed interest rate of 4.39% on the notional amount and the Counterparty agreed to pay the USA Foundation the excess of the variable rate interest due on the note to Regions Bank over the fixed interest with Regions Financial Corporation. Likewise, if the fixed interest exceeded the variable interest, then the USA Foundation would pay the excess to the Counterparty. At June 30, 2005, the fair value of this swap agreement was an obligation of approximately $81,000. This amount was included in the USA Foundation's other liabilities. This swap was settled when the note was repaid in fiscal 2006. For the years ended June 30, 2006 and 2005, the USA Foundation incurred interest expense of $25,000 and $408,000 on a notional amount approximating $11,333,000 and $12,500,000, respectively.

Interest rate swap agreements subject the USA Foundation to market risk associated with changes in interest rates as well as the risk that another party will fail to perform. Notional principal amounts often are used to express the volume of interest rate swap agreements, but the amounts potentially subject to credit risk are substantially less. In the opinion of management, the risk of loss in the event of significant market fluctuations or nonperformance by any counterparty under the derivative financial instrument is not significant.

On April 17, 2003, the Foundation financed the purchase of an office building through issuance of a fixed rate unsecured note payable to AmSouth Bank at 4.55% per annum that matured and was repaid on April 1, 2006. The outstanding balance at June 30, 2005 was $625,000 and interest expense was approximately $23,000 and $29,000 for the years ended June 30, 2006 and 2005, respectively.

(8) Capital Lease Obligation

In September 2006, the University signed a three-year purchase agreement as a method of financing the purchase of certain computer equipment for the USA Hospitals.

Future minimum capital lease payments at September 30, 2006, are as follows (in thousands):

Year ending September 30:		
2007	$	103
2008		103
2009		95
		301
Less amounts representing interest		(24)
Net minimum lease payments	$	277

(Continued)

(9) Net Patient Service Revenue

The Hospitals have agreements with governmental and other third-party payers that provide for reimbursement at amounts different from their established rates. Contractual adjustments under third-party reimbursement programs represent the difference between the Hospitals' billings at established rates for services and amounts reimbursed by third-party payers.

A summary of the basis of reimbursement with major-third party payers follows:

Medicare – Substantially all acute-care services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to patient classification systems that are based on clinical, diagnostic, and other factors. Additionally, the Hospitals are reimbursed for both direct and indirect medical education costs (as defined), principally based on per-resident prospective payment amounts and certain adjustments to prospective rate-per-discharge operating reimbursement payments. The Hospitals generally are reimbursed for certain retroactively settled items at tentative rates, with final settlement determined after submission of annual cost reports by the Hospitals and audits by the Medicare fiscal intermediary. The Hospitals' cost reports have been audited and settled for all fiscal years through 2004. Revenue from the Medicare program accounted for approximately 14% and 18% of the Hospitals' net patient service revenue for the years ended September 30, 2006 and 2005, respectively.

Blue Cross – Inpatient services rendered to Blue Cross subscribers are paid at a prospectively determined per diem rate. Outpatient services are reimbursed under a cost reimbursement methodology. For outpatient services, the Hospitals are reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the Hospitals and audits thereof by Blue Cross. The Hospitals' Blue Cross cost reports have been audited and settled for all fiscal years through 2004. Revenue from the Blue Cross program accounted for approximately 16% and 15% of the Hospitals' net patient service revenue for the years ended September 30, 2006 and 2005, respectively.

Medicaid – Inpatient services rendered to Medicaid program beneficiaries are reimbursed at all-inclusive prospectively determined per diem rates. Outpatient services are reimbursed based on an established fee schedule.

The Hospitals qualify as Medicaid essential providers and, therefore, also receive supplemental payments based on formulas established by the Alabama Medicaid Agency. There can be no assurance that the Hospitals will continue to qualify for future participation in this program or that the program will not ultimately be discontinued or materially modified.

Revenue from the Medicaid program accounted for approximately 33% and 36% of the Hospitals' net patient service revenue for the years ended September 30, 2006 and 2005, respectively.

Other – The Hospitals have also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The bases for payments to the Hospitals under these agreements include discounts from established charges and prospectively determined daily and case rates.

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The composition of net patient service revenue for the years ended September 30, 2006 and 2005 follows (in thousands):

		2006	2005
Gross patient service revenue	$	394,741	397,713
Less provision for contractual and other adjustments		118,230	121,771
Less provision for bad debts		75,138	74,529
	$	201,373	201,413

Changes in estimates related to prior cost reporting periods resulted in an increase of approximately $2,805,000 in net patient service revenue for the year ended September 30, 2006.

(10) Hospital Lease

Background

In December 2005, the University and Infirmary Health System, Inc. (the "Infirmary") entered into a Lease Agreement (the "Lease") in which the University agreed to lease certain land, buildings and equipment at its USA Knollwood Hospital campus to the Infirmary. Assets leased include the Knollwood 124-bed acute care hospital, the Knollwood 191-bed long-term care acute hospital and, with the exception of four condominium units not owned by the University, four professional office buildings located on the Knollwood campus. Additional assets leased include significantly all of the equipment, fixtures, furnishings and other personal property of the University used in connection with the operation of the hospitals.

The lease was effective as of April 1, 2006 and extends fifty years through March 31, 2056 with an automatic renewal, for an additional forty-nine years, through March 31, 2105. The lease may be terminated after the initial fifty-year term by the Infirmary. Upon the expiration or termination of the lease, the assets, along with responsibility for the operation of such assets, will revert to the University and the University will pay the Infirmary, at fair market value, for any capital improvements to the assets.

Additionally, the lease may be terminated at any time, at the option of the Infirmary, in the event that a change in any law, statute, rule, or a regulation of any governmental or other regulatory body or any third-party payment program is deemed by the Infirmary to be significant. Significance is defined as anything that materially affects the operations, including financial and otherwise, of the hospital. If the Infirmary exercises this option, the University has the option of paying the Infirmary an amount equal to the fair market value of the capital improvements to the leased assets or selling the leased assets to the Infirmary for an amount equal to their fair market value. The University's management does not anticipate that this option will be exercised by the Infirmary.

Also in December 2005, and in connection with the lease, the University and Infirmary executed a promissory note, due in June 2006, in which the University agreed to pay the Infirmary $2,927,000, plus interest at an annual rate of 3.25%. This note was given in consideration for approximately 6.7 acres of land in the vicinity of the Mobile Infirmary Medical Center and the University of South Alabama

(Continued)

Children's and Women's Hospital. The Mitchell Cancer Institute is currently being constructed on this property.

Financial Considerations

The total amount of lease payments due the University was based on the fair market value of the assets, $32,418,000, as appraised in September 2005. The allocation of the appraised fair market value is $29,370,000 for the land and buildings and $3,048,000 for medical equipment, office furnishings and other equipment.

Upon execution of the lease, a partial lease prepayment in the amount of $7,418,000 was made by the Infirmary. This prepayment consisted of cash and a credit for the promissory note executed in consideration for the property as described above. The specific components of the prepayment were as follows

Cash	$	4,460,000
Credit for promissory note		2,927,000
Interest on promissory note		31,000
	$	7,418,000

In addition to the prepayment, required lease payments by the Infirmary to the University are as follows:

- Years one through five of the initial lease term - $83,333 per month ($1,000,000 annually)
- Years six through ten of the initial lease term - $104,168 per month ($1,250,000 annually)
- Years eleven through fifteen of the initial lease term - $125,000 per month ($1,500,000 annually)
- Years sixteen through thirty of the initial lease term – The monthly payment will be the remaining unpaid balance of the lease payments amortized over years sixteen through thirty using an interest rate calculated from the immediately previous 15-year monthly average of the 20-year state and local tax exempt general obligation bond issues as determined by the United States Federal Reserve System. The remaining unpaid balance at the end of year fifteen, $17,401,000, is derived by taking the initial unpaid balance of rent due after the partial lease prepayment, $25,000,000 plus accrued interest at an annual rate of 3.75%, less monthly lease payments.
- Years thirty-one through fifty of the initial lease term - $1 annually
- Year fifty-one through ninety-nine of the extended lease term - $1 annually

For reporting purposes, management assumed that the interest rate utilized in years sixteen through thirty would remain at 3.75%. This assumption will be reviewed, and amortization schedules adjusted, if necessary, when the actual interest rate is determined.

Financial Statement Presentation

As required by FASB Statement No. 13, related to leases involving both real property and equipment, the equipment component of the lease must be considered separately in determining whether or not the lease is a capital or an operating lease. As such, the University has bifurcated the lease into an equipment component and a real property component based on the appraised fair value of each such component. The

financial considerations of the lease are then applied to, and the accounting treatment is determined for, each component based on this bifurcation.

Pursuant to FASB Statement No. 13, the equipment component of the lease is considered a capital lease (sales-type lease) and as such has been recorded as a capital lease receivable, both current and non-current, in the accompanying basic financial statements of the University. Equipment with a cost and accumulated depreciation of approximately $14,643,000 and $12,812,000, respectively, has been written off and a resulting gain on the sale of assets in the amount of $1,217,000 has been recognized. The capital equipment lease is being amortized over a five-year period at a fixed rate of 3.75%. Future receipts from this capital lease are expected as follows:

Year ending September 30:		
2007	$	515,000
2008		515,000
2009		515,000
2010		515,000
2011		214,000
		2,274,000
Less amounts representing interest		(182,000)
Total capital lease receivable	$	2,092,000

The component of the lease attributable to land and buildings is considered an operating lease. As such, lease revenue will be recorded as it is earned over the ninety-nine year lease term (the fifty-year initial term and the forty-nine year automatic renewal term). The expected total lease payments to be received over the next thirty years are approximately $41,036,000. These total receipts will be recognized as revenue in the amount of approximately $478,000 annually. Payments received in excess of this amount, along with cash and other consideration already received in the amount of $6,721,000, will be deferred and amortized over the ninety-nine year lease term.

(11) Employee Benefits

(a) Retirement and Pension Plans

Employees of the University are covered by two pension plans: a cost sharing multiple-employer defined benefit pension plan administered by the Teachers' Retirement System of the State of Alabama (TRS), and a defined contribution pension plan.

Permanent employees of the University participate in TRS, a public retirement system created by an act of the State Legislature, with benefit provisions established by the Code of Alabama. Responsibility for general administration and operation of the TRS is vested in the Board of Control (currently 14 members). Benefits fully vest after 10 years of full-time, permanent employment. Vested employees may retire with full benefits at age 60 or after 25 years of service. Participating retirees may elect the maximum benefit, or may choose among four other monthly benefit options.

Under the maximum benefit, participants are allowed 2.0125% of their average final salary (average of three highest years of annual compensation during the last ten years of service) for each year of service. The TRS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to the Retirement Systems of Alabama, P.O. Box 302150, Montgomery, Alabama 36130-2150, or by calling (334) 832-4140.

All employees covered by this retirement plan must contribute 5% of their eligible earnings to TRS. An actuary employed by the TRS Board of Control establishes the employer-matching amount annually. During 2006, 2005 and 2004, the University made total contributions of $18,468,000, $15,758,000, and $14,169,000 (100% of the required contributions), respectively, to TRS on behalf of participants, which represents 8.17%, 7.03%, and 6.56%, respectively, of each participant's gross earnings. The University's payroll for all employees was approximately $254,325,000 and $256,954,000 in 2006 and 2005, respectively. Total payroll for University employees participating in the Teachers' Retirement System of Alabama was approximately $226,042,000 and $224,158,000 in 2006 and 2005, respectively.

The defined contribution pension plan covers certain academic and administrative employees, and participation by eligible employees is optional. Under this plan, administered by Teachers Insurance and Annuity Association – College Retirement Equities Fund (TIAA-CREF), contributions by eligible employees are matched equally by the University up to a maximum of 3% of current annual pay. The University and the employees each contributed $836,000 and $789,000 in 2006 and 2005, respectively, representing 441 and 428 employees participating in this Plan.

(b) Compensated Absences

Regular University employees accumulate vacation and sick leave, subject to maximum limitations, at varying rates depending upon their employee classification and length of service. Upon termination of employment, employees are paid all unused accrued vacation at their regular rate of pay up to a maximum of two times their annual accumulation rate. The accompanying statements of net assets include accruals for vacation pay of approximately $14,580,000 and $13,601,000 at September 30, 2006 and 2005, respectively. No accrual is recognized for sick leave benefits since no terminal cash benefit is available to employees for accumulated sick leave.

(c) Other Postretirement Employee Benefits

In September 2003, the State of Alabama Legislature passed legislation that requires all colleges and universities to fund the healthcare premiums of its participating retirees. In prior years, such costs have been paid by the State. Beginning in October 2003, the University was assessed a monthly premium by the Public Education Employees' Health Insurance Plan (PEEHIP) based on the number of retirees in the system and an actuarially determined premium. During the years ended September 30, 2006 and 2005, the University's expense related to PEEHIP was $4,576,000 and $3,548,000, respectively.

(12) Risk Management

The University and USAHSF participate in the professional liability trust fund and the University participates in the general liability trust fund. Both funds are administered by an independent trustee. These trust funds are revocable and use contributions by the University and USAHSF, together with earnings thereon, to pay liabilities arising from the performance of its employees, trustees and other individuals acting on behalf of the University. If the trust funds are ever terminated, appropriate provision for payment of related claims will be made and any remaining balance will be distributed to the University and USAHSF in proportion to contributions made.

As discussed in note 1, the PLTF and GLTF are blended component units of the University, as defined by GASB Statement No. 14, and as such are included in the basic financial statements of the University for the years ended September 30, 2006 and 2005. Claims and expenses are reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. Those losses include an estimate of claims that have been incurred but not reported and the future costs of handling claims. These liabilities are generally based on actuarial valuations and are reported at their present value.

The University participates in a self-insured health plan, administered by an unaffiliated entity. Administrative fees paid by the University for such services were approximately $1,257,000 and $1,155,000 in 2006 and 2005, respectively. Contributions by the University and its employees, together with earnings thereon, are used to pay liabilities arising from healthcare claims. It is the opinion of University administration that plan assets are sufficient to meet future plan obligations.

The changes in the total self-insurance liabilities for the years ended September 30, 2006 and 2005 for the PLTF, GLTF and health plan are summarized as follows (in thousands):

		2006	2005
Balance, beginning of year	$	34,485	31,623
Liabilities incurred and other additions		29,955	26,949
Claims, administrative fees paid and other reductions		(28,586)	(24,087)
Balance, end of year	$	35,854	34,485

(13) Other Related Parties

The South Alabama Medical Science Foundation (SAMSF) is a not-for-profit corporation that exists for the purpose of promoting education and research at the University. SAMSF reimburses the University for certain administrative expenses and other related support services. Total amounts received for such expenses were approximately $958,000 and $770,000 in 2006 and 2005, respectively, and are reflected as private grants and contracts in the accompanying statements of revenues, expenses, and changes in net assets.

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The USA Research and Technology Corporation (the Corporation) is a not-for-profit corporation that exists for the purpose of furthering the educational and scientific mission of the University by developing, attracting, and retaining technology and research industries in Alabama that will provide professional and career opportunities to the University's students and faculty. Included in liabilities of the Corporation is a commercial mortgage note payable to Whitney National Bank, with annual interest of 6.00% payable monthly through January 2014. This note is not reflected in the University's statement of net assets nor is the note guaranteed by the University. The note payable is secured by a security interest in the ground lease with respect to the parcel of land on which the Corporation's building stands, a security interest in the Corporation's building, a security interest in tenant leases and a security interest in income received by the Corporation for rental of the building.

(14) Commitments and Contingencies

(a) Grants and Contracts

At September 30, 2006 and 2005, the University had been awarded approximately $49,102,000 and $32,400,000, respectively, in grants and contracts for which resources had not been received and for which reimbursable expenditures had not been made for the purposes specified. These awards, which represent commitments of sponsors to provide funds for research or training projects, have not been reflected in the accompanying basic financial statements as the eligibility requirements of the award have not been met. Advances include amounts received from grant and contract sponsors which have not been earned under the terms of the agreements and, therefore, have not yet been included in revenues in the accompanying basic financial statements. Federal awards are subject to audit by Federal agencies. The University's management believes any adjustment from such audits will not be material.

(b) Lines of Credit

In connection with the University's purchasing card program, the University has also established a $2,000,000 line of credit with FIA Card Services, N.A., with a 0% interest rate. No funds were advanced under the line of credit at September 30, 2005. At September 30, 2006, $32,000 was advanced from this line of credit and is reflected in accounts payable and accrued liabilities.

In connection with the Hospitals' participation in the State of Alabama Medicaid Program, the University has established a $1,476,000 irrevocable standby letter of credit with Regions Bank with a variable interest rate of 0.480% points over LIBOR, not to exceed 6.9%. The Alabama Medicaid Agency is the beneficiary of this letter of credit. No funds were advanced under this letter during the years ended September 30, 2006 and 2005.

(c) Litigation

Various claims have been filed against the University alleging discriminatory employment practices and other matters. University administration and legal counsel are of the opinion the resolution of these matters will not have a material effect on the financial position or the statement of revenues, expenses, and changes in net assets of the University.

In December 1999, the University and the State of Alabama entered into an "Agreement to Dismiss Litigation." This agreement called for the dismissal of the University's pending lawsuit against tobacco manufacturers in return for the payment of $20,000,000 from the State to the University.

The timing of the receipt of these funds is subject to availability. The payment is to be made over a period of not more than ten years. Pursuant to a separate agreement, 14% of all funds received are to be paid to the attorneys who represented the University in the litigation. At September 30, 2006, $2,000,000 related to this settlement has been received and was recognized as state appropriations in prior years. Additionally, $2,500,000 related to the settlement has been allocated to the University by the Alabama Public School and College Authority, all of which has been expended by the University as of September 30, 2006. Accordingly, $15,500,000 of the original amount remained unpaid at September 30, 2006. At September 30, 2006, the $15,500,000 has not been recorded in the University's basic financial statements because it is considered to be a contingent asset in accordance with FASB Statement No. 5.

(15) Functional Information

Operating expenses by functional classification for the years ended September 30, 2006 and 2005 are listed below (in thousands). In preparing the basic financial statements, all significant transactions and balances among accounts have been eliminated.

	2006	2005
Instruction	$ 91,832	84,870
Research	19,828	16,898
Public service	46,677	39,373
Academic support	16,546	15,406
Student services	17,348	16,828
Institutional support	20,193	15,612
Operation and maintenance of plant	15,552	13,484
Scholarships	735	1,129
Hospital	198,590	206,193
Auxiliary enterprises	14,577	13,792
Depreciation	18,460	18,661
Other	2,277	2,341
	$ 462,615	444,587

(16) Significant New Accounting Pronouncements

In June 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits (OPEB) other than Pensions.* GASB Statement No. 45 establishes standards for the measurement, recognition and disclosure of OPEB expenses and related liabilities and is effective for the University for the year ending September 30, 2008. In September 2006, the GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*. GASB Statement No. 48 establishes criteria governing whether proceeds received from the sale or pledge of receivables should be reported as revenue or as a liability and will be effective for the year ending September 30, 2008.

The effect of the implementation of GASB Statements Nos. 45 and 48 on the University has not been determined.

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS AND OMB CIRCULAR A-133 REPORTS

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Expenditures of Federal Awards

Year ended September 30, 2006

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Federal expenditures
Student Financial Aid Cluster*:		
U.S. Department of Education:		
Federal Pell Grant Program	84.063	$ 8,346,181
Federal Supplemental Educational Opportunity Grant Program	84.007	788,978
Federal Family Educational Loan Program	84.032	58,346,662
Federal College Work Study Program	84.033	336,355
Federal Perkins Loan Program	84.038	1,191,239
Academic Competitiveness Grant	84.375	46,950
National Science and Mathematics Access to Retain Talent Grant	84.376	128,428
Total U.S. Department of Education		69,184,793
Total Student Financial Aid Cluster		69,184,793
Research and Development Cluster*:		
Direct programs:		
U.S. Department of Health and Human Services:		
Food and Drug Administration Research	93.103	8,974
Biological Response to Environmental Health Hazard	93.113	249,187
Research Related to Deafness and Communicative Disorders	93.173	248,269
Centers for Disease Control and Prevention – Investigations and Technical Assistance	93.283	297,590
Comparative Medicine	93.306	221,940
Minority Health and Health Disparities Research	93.307	455,328
Research Infrastructure	93.389	1,402,306
Cancer Cause and Prevention Research	93.393	334,189
Cancer Detection and Diagnosis Research	93.394	146,087
Cancer Treatment Research	93.395	29,489
Cancer Biology Research	93.396	36,221
Cell Biology and Biophyics Research	93.821	826
Heart and Vascular Disease Research	93.837	1,106,646
Lung Disease Research	93.838	4,134,810
Diabetes Endocrinology and Metabolism Research	93.847	241,379
Extramural Research Programs in Neurosciences and Neurological Disorders	93.853	338,194
Microbiology and Infectious Diseases Research	93.856	1,751,313
Aging Research	93.866	269,289
Vision Research	93.867	216,960
Specially Selected Health Projects	93.888	292,208
Health Communities Access Programs Demonstration Authority	93.989	19,359
National Science Foundation:		
Mathematical and Physical Sciences	47.049	134,731
Geosciences	47.050	170,443

(Continued)

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Expenditures of Federal Awards

Year ended September 30, 2006

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Federal expenditures
Biological Sciences	47.074	$ 132
Social, Behavioral, and Economic Sciences	47.075	16,934
Polar Programs	47.078	43,727
Environmental Protection Agency:		
Environmental Protection Comprehensive Research Grants	66.511	647,832
U.S. Department of Commerce:		
Habitat Conservation	11.463	1,067,270
Centers for Disease Control:		
Squirrel Monkey	93.200-203-01848	74,794
U.S. Department of Defense:		
Basic Scientific Research	12.431	12,028
Military Medical Research and Development	12.420	180,603
U.S. Department of Energy:		
Office of Science Financial Assistance Program	81.049	38,891
Renewal Energy Research and Development	81.087	116,615
U.S. Department of Transportation:		
Highway Planning and Construction	20.205	193,028
University Transportation Centers Program	20.701	171,892
U.S. Department of Interior:		
National Cooperative Geologic Mapping Program	15.810	739
Conservation Grants Private Stewardship for Imperiled Species	15.632	48,877
U.S. Department of Justice:		
Developing, Testing and Demonstrating Promising New Programs	16.541	665,115
National Institute for Juvenile Justice and Delinquency Prevention	16.542	96,247
Total direct programs		15,480,462

(Continued)

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Expenditures of Federal Awards

Year ended September 30, 2006

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Federal expenditures
Pass-through programs:		
Pass-through from National Institutes of Health:		
University of Pennsylvania	93.213	$ 4,430
Sequella, Inc.	93.371	11,716
Mallard Medical, Inc.	93.838	22,090
Alabama Department of Public Health	93.283	15,000
Columbia University	93.242	34,820
Duke University Medical Center	93.856	33,271
Moorehouse School of Medicine	93.004	15,008
University of Alabama Birmingham	93.856	95,544
Westat, Inc.	93.395	12,309
Yale University	93.853	12,801
Rockefeller University	93.839	13,824
Emory University	93.839	3,539
National Childhood Cancer Foundation	93.395	23,994
University of Texas	93.853	58,035
University of Alabama at Birmingham	93.113	21,240
Pass-through from National Science Foundation:		
Florida State University	47.049	2,432
University of Georgia	47.074	4,606
University of Alabama	47.076	131,720
University of Alabama in Huntsville	47.076	72,729
Tuskegee University	47.076	55,066
Bigelow Laboratory for Ocean Sciences	47.078	38,332
Pass-through from U.S. Department of Commerce:		
University of Southern Mississippi	11.417	1,094
Alabama Department of Conservation and Natural Resources	11.419	133,357
Pass-through from U.S. Department of Interior:		
Alabama Department of Conservation and Natural Resources	15.605	55,877
Louisiana State University	15.000	14,816
Pass-through from U.S. Department of Health and Human Services:		
Northrop Grumman	93.243	(3,270)
Pass-through from U.S. Department of Transportation:		
Volkert and Associates, Inc.	20.205	85,774
University of Alabama at Birmingham	20.OGCA-1801Y	14,257
Kilgore Consulting Management	20.215	23,101

(Continued)

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Expenditures of Federal Awards

Year ended September 30, 2006

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Federal expenditures
Pass-through from U.S. Department of Energy:		
Lawrence Livermore National Laboratory	10.073	$ 38,630
Radiance Technologies, Inc.	81.049	771,410
Pass-through from U.S. Department of Housing and Urban Development:		
The Mitchell Company	14.866	33,915
Pass-through from Environmental Protection Agency:		
Mobile Water and Sewer Service	66.606	15,063
Pass-through from Exxon Valdez Oil Spill Trustee Council:		
Prince William Sound Science Center	04.PWSSC-02	67,358
Prince William Sound Science Center	04.PWSSC-05	44,670
Prince William Sound Science Center	04.04-10-14	462
Prince William Sound Science Center	04.05-10-09-3	8,069
Pass-through from U.S. Department of Defense:		
Naval Research Laboratory	12.300	51,952
Radiance Technologies, Inc.	12.630	782,075
Auburn University	12.431	36,736
Pass-through from U.S. Department of Justice:		
Mobile Children's Policy Council	16.585	11,338
Pass-through from NASA:		
University of Alabama in Huntsville	43.002	29,658
Total pass-through programs		2,898,848
Total Research and Development Cluster		18,379,310
Other federal assistance:		
Direct programs:		
U.S. Department of Education:		
TRIO Student Support Services	84.042A	(56,192)
Trio Talent Search	84.044A	290,844
Trio Upward Bound	84.047A	142,518
Hurricane Education Recovery	84.938	84,405

(Continued)

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Expenditures of Federal Awards

Year ended September 30, 2006

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Federal expenditures
U.S. Department of Health and Human Services:		
Maternal and Child Health Federal Consolidated Programs	93.110	$ 696,490
Telehealth Network Grants	93.211	106,240
Advanced Education Nursing Grant Programs	93.247	1,055,795
Advanced Education Nursing Traineeships	93.358	259,505
Basic Nurse Education and Practice Grants	93.359	449,629
U.S. Department of Energy*:		
Office of Science Financial Assistance Program	81.049	3,725,930
Health Resources and Services Administration:		
Grants for Residency Training for General Pediatrics	93.884	288,918
Specially Selected Health Projects	93.888	3,124
Coordinated HIV Services and Access to Research for Children, Youth, Women, and Families	93.153	344,255
Healthcare and Other Facilities*	93.887	3,785,444
National Science Foundation:		
Education and Human Resources	47.076	66,151
Biological Sciences	47.074	94,914
U.S. Department of Justice:		
Community Prosecution and Project Safe Neighborhoods	16.609	9,056
Edward Byrne Memorial Formula Grant Program	16.579	16,584
U.S. Agency for International Development:		
USAID Foreign Assistance for Programs Overseas	98.001	105,680
U.S. Department of Transportation:		
National Motor Carrier Safety	20.218	462,209
Federal Transit – Capital Investment Grants	20.500	19,219
Americorp:		
Corporation of National and Community Service	94.006	(500)
Total direct programs		11,950,218

(Continued)

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Expenditures of Federal Awards

Year ended September 30, 2006

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Federal expenditures
Pass-through programs:		
Pass-through from U.S. Department of Education:		
Alabama Department of Education	84.027	$ 37,802
Alabama Department of Education	84.323A	56,906
Alabama Commission on Higher Education	84.367B	226,412
Alabama Department of Education	84.366B	2,924,319
National Writing Project	84.928A	34,466
Mobile County Public Schools	84.010	(1,949)
Pass-through from NASA:		
Alabama Department of Education	43.002	80,120
University of Alabama in Huntsville	43.002	25,934
Pass-through from National Institutes of Health;		
Mayo Foundation for Medical Research	93.853	606
University of Maryland Baltimore	93.879	3,484
University of Pittsburg	93.853	554
Pass-through from U. S. Homeland Security:		
Mobile County Emergency Management Agency	97.067	2,796
Pass-through from Small Business Administration:		
University of Alabama at Birmingham	59.037	123,018
Pass-through from U.S. Department of Justice:		
Mobile County Public Schools	16.585	1,093
Pass-through from States Administration on Aging:		
South Alabama Regional Planning Commission	93.051	9,980
Pass-through from Substance Abuse and Mental Health Administration:		
Mobile Mental Health	93.276	7,730
Pass-through from Administration for Children and Families:		
University of Alabama	93.658	51,914
Pass-through from Health Resources Services Administration:		
Alabama Department of Public Health	93.926	15,000
Alabama Department of Public Health	93.289	113
Florida State Universitiy	93.969	76,939
Northrup Grumman Information Technology	93.243	219,378
Pass-through from U.S. Department of Defense:		
University of Alabama Birmingham	12.002	22,383

(Continued)

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Expenditures of Federal Awards

Year ended September 30, 2006

Federal grantor/pass-through grantor/ program or cluster title	Federal CFDA number	Federal expenditures
Pass-through from U.S. Department of Health and Human Services:		
Alabama Department of Public Health	93.003	$ 1,139,370
Alabama Department of Public Health	93.283	21,138
Total pass-through programs		5,079,506
Total other federal assistance		17,029,724
Total federal expenditures		$ 104,593,827

* Denotes major program.

See accompanying notes to schedule of expenditures of federal awards.

See accompanying independent auditors' report on supplementary information.

(1) Basis of Presentation

The accompanying schedule of expenditures of federal awards includes the federal grant activity of University of South Alabama (the University) and is presented in accordance with U.S. generally accepted accounting principles. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.* Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

Expenditures listed on the accompanying schedule of expenditures of federal awards, except for Perkins Loans, Federal Family Educational Loan (FFEL) Programs, Parent Loans-PLUS loans, Loans to Disadvantaged Students and Health Education Assistance Loans (HEAL), represent actual expenditures incurred under the accrual basis of accounting for the year ended September 30, 2006. The loan programs representing loans made by the University are included in notes receivable in the accompanying 2006 statement of net assets and consist of the following:

Perkins loan program	$	4,365,005
Loans to disadvantaged students		2,551
Health professional loans		170,000
		4,537,556
Less outstanding balance of loans granted in previous years		(3,346,317)
New loans granted to eligible students of the University	$	1,191,239

The FFEL and HEAL federal awards represent loans received by students of the University during fiscal year 2006 which were not made by the University. Accordingly, FFEL and HEAL amounts are not reflected in the University's basic financial statements.

(2) Contingencies

These federal programs are subject to financial and compliance audits by grantor agencies which, if instances of material noncompliance are found, may result in disallowed expenditures and affect the University's continued participation in specific programs.

(Continued)

(3) Federal Family Education Loan Programs

During fiscal year ended September 30, 2006, the University processed the following amount of new loans under the Federal Family Education Loan Program:

	CFDA #		Amount expended
Subsidized Stafford loans	84.032	$	24,511,407
Unsubsidized Stafford loans	84.032		30,395,417
Parents' loans for undergraduate students	84.032		3,439,838
Total		$	58,346,662

(4) Administrative Cost Allowance

The accompanying schedule of expenditures of federal awards includes administrative costs for the Federal Perkins Loan program of $108,598.

(Continued)

(5) Subrecipients

Of the federal expenditures presented in the schedule of expenditures of federal awards, the University provided federal awards to subrecipients under the following programs:

	Federal CFDA #	Amounts expended
Direct programs:		
Habitat Conservation	11.463	$ 262,443
National Motor Carrier Safety	20.218	10,620
Environmental Protection Comprehensive Research Grants	66.511	280,494
Adolecesent Family Life Research Grants	93.110	487,638
Biological Response to Environmental Health Hazard	93.113	30,718
Coordinated HIV Services and Access to Research for Children, Youth, Women, and Families	93.153	6,652
Heart and Vascular Disease Research	93.837	3,232
Lung Disease Research	93.838	18,569
Renewable Energy Research and Development	81.087	117,819
Pass-through programs:		
U.S. Department of Health and Human Services/ Northrop Grumman	93.243	54,964
U.S. Department of Education/D.A. Brown and Associates PLLC	20.205	10,000
Health Resources and Services Administration/Alabama Department of Public Health	93.926	15,000
U.S. Department of Commerce/Alabama Department of Conservation and Natural Resources	11.419	57,396
U.S. Department of Health and Human Services/ Alabama Department of Public Health	93.003	4,698
U.S. Department of Energy/Radiance Technologies, Inc.	81.049	317,845
U.S. Department of Education/Alabama Department of Education	84.367B	43,735
U. S. Department of Education/Alabama Department of Education	84.366B	226,415
U.S. Department of Education/Alabama Commission on Higher Education	84.367B	63,353
		$ 2,011,591

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Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Board of Trustees
University of South Alabama:

We have audited the basic financial statements of the University of South Alabama, a component unit of the State of Alabama, (the University) and its aggregate discretely presented component units as of and for the year ended September 30, 2006, and have issued our report thereon dated November 10, 2006. We did not audit the 2006 consolidated financial statements of the University of South Alabama Foundation, which represents 91%, 100% and 44%, respectively, of the 2006 assets, net assets and revenues of the aggregate discretely presented component units. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the University of South Alabama Foundation, is based on the report of the other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the University's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

Internal Control over Financial Reporting

In planning and performing our audit, we considered the University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted certain matters that we have reported to management of the University in a separate letter dated November 10, 2006.

(Continued)
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This report is intended solely for the information and use of the board of trustees, management, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 10, 2006

KPMG LLP
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Independent Auditors' Report on Compliance with Requirements Applicable to Each Major Program and on Internal Control over Compliance in Accordance with OMB Circular A-133

The Board of Trustees
University of South Alabama:

Compliance

We have audited the compliance of the University of South Alabama (the University) with the types of compliance requirements described in the *U. S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement (Compliance Supplement)* that are applicable to each of its major federal programs for the year ended September 30, 2006, except those requirements discussed in the third following paragraph. The University's major federal programs are identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts and grants applicable to each of its major federal programs is the responsibility of the University's management. Our responsibility is to express an opinion on the University's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.* Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the University's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the University's compliance with those requirements.

In our opinion, the University complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended September 30, 2006, other than those requirements discussed in the following paragraph. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as item 2006-01, 2006-02, 2006-03, 2006-04, 2006-05, 2006-06, and 2006-07.

We did not audit the University's compliance with requirements governing maintaining contact with and billing borrowers and processing deferment and cancellation requests and payments for the Federal Perkins Loan Program. Those requirements govern functions that are performed by Affiliated Computer Services, Inc. (ACS). Since we did not apply auditing procedures to satisfy ourselves as to compliance with those requirements, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on compliance with those requirements.

(Continued)
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ACS's compliance with the requirements governing the functions that it performs for the University was examined by accountants for the servicer whose report has been furnished to us. The report of the accountants for the servicer indicates that compliance with those requirements was examined in accordance with the Department of Education's Audit Guide, *Compliance Audits (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*. Based on our review of the service organization accountants' report, we have determined that all of the compliance requirements included in the *Compliance Supplement* that are applicable to each of the major programs in which the University participates are addressed in either our report or the report of the service organization accountants. Further, based on our review of the service organization accountants' report, we have determined that it does not contain any findings of noncompliance that would have a direct and material effect on the University's major programs.

Internal Control over Compliance

The management of the University is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered the University's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Requirements governing maintaining contact with and billing borrowers and processing deferment and cancellation requests and payments for the Federal Perkins Loan Program are performed by ACS. Internal control over compliance relating to such functions was reported on by accountants for the servicer in accordance with the Department of Education's Audit Guide, *Compliance Audits (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers.* A copy of the service organization accountants' report has been furnished to us. However, the scope of our work did not extend to internal control maintained at ACS.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the board of trustees, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 10, 2006

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Findings and Questioned Costs

Year ended September 30, 2006

I – Summary of Auditor's Results

Financial Statements

Type of auditors' report issued:	Unqualified
Internal control over financial reporting:	
Material weakness(es) identified?	_____ yes __x__ no
Reportable condition(s) identified that are not considered to be material weaknesses?	_____ yes __x__ none reported
Noncompliance material to financial statements noted?	_____ yes __x__ no

Federal Awards

Internal control over major programs:	
Material weakness(es) identified?	_____ yes __x__ no
Reportable condition(s) identified that are not considered to be material weaknesses?	_____ yes __x__ none reported
Type of auditors' report issued on compliance for major programs:	Unqualifed
Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133?	__x__ yes _____ no

Identification of major programs:

CFDA Numbers	Name of Federal Program Cluster
84.063, 84.007, 84.032, 84.033, 84.038, 84.375, 84.376	Student Financial Aid Cluster
Various	Research and Development Cluster
81.049	U.S. Department of Energy Office of Science Financial Assistance Program
93.887	Health Resources and Services Administration Healthcare and Other Facilities

Dollar threshold used to distinguish between type A and type B programs:	$3,000,000
Auditee qualified as low-risk auditee?	__x__ yes _____ no

(Continued)

UNIVERSITY OF SOUTH ALABAMA
(A Component Unit of the State of Alabama)

Schedule of Findings and Questioned Costs

Year ended September 30, 2006

Section II – Findings Related to Financial Statements Reported in Accordance with *Government Auditing Standards*

There were no findings related to the financial statements reported in accordance with *Government Auditing Standards*.

(Continued)

Section III – Federal Award Findings and Questioned Costs relating to Federal Awards

Finding No. 2006-01

Cash Management

Research and Development Cluster - Various CFDA Numbers

Health Resources and Services Administration Healthcare and Other Facilities Grant - 93.887

Criteria

The University should strengthen its internal control procedures related to cash management to ensure that federal expenditure drawdown requests and related journal entries are properly approved. Approval should be formally documented.

Condition

The University did not properly document approval of the drawdown requests and related journal entries.

Questioned Costs

None

Context

During our review of the internal controls over cash management, thirty federal expenditure drawdown requests and thirty related journal entries were tested for proper approval and we noted nine exceptions. Five were related to the Health Resources and Services Administration Healthcare and Other Facilities Grant and four were related to the Research and Development Cluster.

Effect

The University is not in compliance with its internal control policies regarding documentation of approval of federal expenditure drawdown requests and related journal entries.

Recommendation

The University should ensure that appropriate personnel in Grants and Contracts Accounting review and document approval of federal expenditure drawdown requests and related journal entries.

Management Views

Currently all drawdowns of federal funds are discussed with, and approved by the Manager of Grants and Contracts Accounting or the Associate Controller prior to being made. Management will ensure that these approvals are adequately documented.

(Continued)

Finding No. 2006-02

Equipment and Real Property Management

Research and Development Cluster – Various CFDA Numbers

Health Resources and Services Administration Healthcare and Other Facilities Grant - 93.887

Criteria

OMB Circular A-110 requires that property records contain the following information about equipment purchased with federal funds: description, source, title holders, acquisition date and cost, percentage of federal participation in the cost, location, condition and any ultimate disposal costs.

Condition

The University did not state the condition of the equipment on the property system for twelve equipment purchases.

Questioned Costs

None

Context

Of the sixteen equipment purchases tested, there were twelve exceptions. One exception related to the Health Resources and Services Administration Healthcare and Other Facilities Grant and eleven exceptions related to the Research and Development Cluster.

Effect

The University is not in compliance with federal policies regarding designating the condition of the equipment in the property system.

Recommendation

The University should review the new property system to determine if there is a field for this information and begin using this field.

Management Views

Management will identify a field in the new property system for this information and ensure that the information is recorded in the field.

(Continued)

Finding No. 2006-03

Equipment and Real Property Management

Health Resources and Services Administration Healthcare and Other Facilities Grant - 93.887

Criteria

OMB Circular A-110 requires that property records contain the following information about equipment purchased with federal funds: description, source, title holders, acquisition date and cost, percentage of federal participation in the cost, location, condition and any ultimate disposal costs.

Condition

The University did not tag one equipment purchase or designate in the property system that the equipment purchased, if sensitive, was not taggable.

Questioned Costs

None

Context

Of the sixteen equipment purchases tested, there was one exception.

Effect

The University is not in compliance with federal policies regarding location of equipment and real property.

Recommendation

The University should review equipment purchases to ensure that the equipment is tagged or designated in the system as not taggable.

Management Views

Management will re-emphasize to accounting personnel capital assets purchased with federal funds are appropriately tagged.

(Continued)

Finding No. 2006-04

Reporting

Health Resources and Services Administration Healthcare and Other Facilities Grant 93.887

Criteria

OMB Circular A-133 requires timely submission of required reports.

Condition

The University did not file the required construction reports for the first and second quarter within 30 days.

Questioned Costs

None

Context

Of the construction reports filed by the University, two of the four quarterly reports were late. All other reports tested were filed on a timely basis.

Effect

The University is not in compliance with federal policies regarding timely submission of required reports.

Recommendation

The University should establish policies and procedures to ensure timely submission of reports.

Management Views

Responsibility for filing construction reports has been consolidated within the Construction and Facilities Department to ensure that all future reports are filed timely.

(Continued)

Finding No. 2006-05

Reporting

U.S. Department of Energy Office of Science Financial Assistance Program – 81.049

Criteria

OMB Circular A-133 requires timely submission of required reports.

Condition

The University did not file the required quarterly report for the first quarter within 30 days.

Questioned Costs

None

Context

Of the various reports filed by the University, one of the four quarterly reports was filed late. All other reports tested were filed on a timely basis.

Effect

The University is not in compliance with federal policies regarding timely submission of required reports.

Recommendation

The University should establish policies and procedures to ensure timely submission of reports.

Management Views

The report in question was filed at 32 days. The agency uses the 30 days in this type of report as a "rule of thumb" and does not consider it late if it is reasonably close to the 30 days. Management will periodically review the work lists to ensure that the reports are filed in a timely manner.

(Continued)

Finding No. 2006-06

Allowable Cost/Cost Principles

Research and Development Cluster – Various CFDA Numbers

U.S. Department of Energy Office of Science Financial Assistance Program - 81.049

Criteria

OMB Circular A-122, Attachment B.8 requires that confirmation of salaries be performed by a person with first-hand knowledge of the effort or the principal investigator or responsible official(s) using suitable means of verification that the work was performed as outlined in Circular A-21, J.10.

Condition

In accordance with the University's policy, the University did not confirm on a timely basis salaries by a person with first-hand knowledge of the effort or the principal investigator or responsible official(s) for twenty of the forty payroll charges tested. However, the University did subsequently receive the required documentation and no questioned costs were noted for the sample selected. In addition, the timeliness of adjustments that are made to the payroll system as a result of the confirmation process should be improved.

Questioned Costs

None

Context

Of the forty payroll charges tested, there were twenty exceptions whereby payroll charged to the grant was not properly confirmed on a timely basis by a person with first-hand knowledge.

Effect

The University is not in compliance with its own policies and with federal policies regarding timely time and effort reporting.

Recommendation

The University should review the current system of time and effort reporting and strengthen the related policies and procedures to ensure that time and effort is being charged on a more timely basis.

Management Views

The existing payroll system is such that the timely completion of effort reports is extremely difficult. Management is currently developing a new electronic effort reporting system as part of implementing a new payroll system which was implemented October 1, 2006. This new system, to be effective with the fall semester of 2006, will assist in ensuring that all time and effort is certified and adjusted in a timely manner.

 (Continued)

Finding No. 2006-07

Reporting

Research and Development Cluster – Various CFDA Numbers

Criteria

OMB Circular A-133 requires timely submission of required reports.

Condition

The University did not file four required progress reports for research and development grants tested by the required deadline.

Questioned Costs

None

Context

Of the program reports filed by the University, four of the twenty-three progress reports tested were filed late. All other reports tested were filed on a timely basis.

Effect

The University is not in compliance with federal policies regarding timely submission of required reports.

Recommendation

The University should establish policies and procedures to ensure timely submission of reports.

Management Views

Management will re-emphasize the importance of the timely filing of reports to the principal investigators and others who are responsible for filing these reports.