



The Pennsylvania Higher Education Foundation, Inc.

Consolidated Annual Financial Report

May 31, 2010 and 2009



KPMG LLP
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Independent Auditors' Report

The Board of Directors
The Pennsylvania Higher Education Foundation, Inc.:

We have audited the accompanying consolidated statements of financial position of The Pennsylvania Higher Education Foundation, Inc. as of May 31, 2010 and 2009, and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Pennsylvania Higher Education Foundation, Inc. as of May 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 3 to the financial statements, although The Pennsylvania Higher Education Foundation, Inc. will continue to operate, it anticipates that it will significantly reduce operations after the May 31, 2011 fiscal year.

KPMG LLP

September 22, 2010

The Pennsylvania Higher Education Foundation, Inc.
 Consolidated Statements of Financial Position
 As of May 31



| | 2010 | 2009 |
|---|---------------------|-------------------|
| Assets: | | |
| Cash | \$ 69,958 | 315,415 |
| Short-term investments | 177,938 | 277,123 |
| Prepaid expenses | - | 4,440 |
| Contributions receivable, net of discount | 1,000,000 | 2,300,000 |
| Long-term investments | 7,529,000 | 21,382,103 |
| Office furnishings and equipment, net of accumulated depreciation | 40,716 | 46,049 |
| Total assets | \$ 8,817,612 | 24,325,130 |
| Liabilities and net assets: | | |
| Liabilities: | | |
| Accrued expenses | \$ 329,596 | 312,520 |
| Grants payable | 601,035 | 5,637,235 |
| Amounts payable to specific organizations as designated by donors | - | 91,563 |
| Total liabilities | 930,631 | 6,041,318 |
| Net assets: | | |
| Unrestricted | 400,747 | 374,437 |
| Temporarily restricted | 7,486,234 | 17,909,375 |
| Total net assets | 7,886,981 | 18,283,812 |
| Total liabilities and net assets | \$ 8,817,612 | 24,325,130 |

See accompanying notes to consolidated financial statements.

The Pennsylvania Higher Education Foundation, Inc.
Consolidated Statements of Activities
For the years ended May 31



| | 2010 | 2009 |
|---|---------------------|---------------------|
| Changes in unrestricted net assets: | | |
| Revenues: | | |
| Donated services | \$ 179,428 | 395,219 |
| Income on long-term investments | 17,027 | 44,307 |
| Gain on sale of fixed asset | 11,015 | - |
| Net unrealized and realized (losses) gains on long-term investments | (1,732) | 6,683 |
| Total revenues | 205,738 | 446,209 |
| Net assets released from restrictions | 10,733,612 | 19,557,593 |
| Increase in unrestricted net assets | 10,939,350 | 20,003,802 |
| Expenses: | | |
| Program services: | | |
| Nursing Education Initiative | | |
| Grants | 10,302,389 | 17,630,730 |
| Other program services | 112,856 | 1,236,805 |
| Total program services | 10,415,245 | 18,867,535 |
| Management and general | 484,285 | 811,483 |
| Fundraising | 13,510 | 273,794 |
| Total expenses | 10,913,040 | 19,952,812 |
| Net change in unrestricted net assets | 26,310 | 50,990 |
| Changes in temporarily restricted net assets: | | |
| Contributions | - | 116,810 |
| Income on short-term investments | 821 | 3,415 |
| Income on long-term investments | 364,880 | 856,086 |
| Net unrealized and realized losses on long-term investments | (55,230) | (2,097,182) |
| Loss from write off of contributions receivable | - | (1,500,000) |
| Net assets released from restrictions | (10,733,612) | (19,557,593) |
| Decrease in temporarily restricted net assets | (10,423,141) | (22,178,464) |
| Decrease in net assets | (10,396,831) | (22,127,474) |
| Net assets at beginning of year | 18,283,812 | 40,411,286 |
| Net assets at end of year | \$ 7,886,981 | 18,283,812 |

See accompanying notes to consolidated financial statements.

The Pennsylvania Higher Education Foundation, Inc.
 Consolidated Statements of Cash Flows
 For the years ended May 31



| | 2010 | 2009 |
|--|---------------------|---------------------|
| Cash flows from operating activities: | | |
| Cash received from donors | \$ 1,300,000 | 1,094,250 |
| Investment income received | 452,907 | 893,912 |
| Grants paid | (15,430,152) | (14,342,045) |
| Cash paid for other program services, management and general, and fundraising expenses | (404,374) | (1,872,057) |
| Net cash used for operating activities | (14,081,619) | (14,225,940) |
| Cash flows from investing activities: | | |
| Proceeds from sales or maturities of long-term investments | 27,844,547 | 81,634,064 |
| Purchases of long-term investments | (14,118,586) | (67,195,641) |
| Proceeds from sales or maturities of short-term investments | 100,007 | 1,085,026 |
| Purchases of short-term investments | (821) | (1,003,415) |
| Proceeds from sale of fixed assets | 11,015 | - |
| Net cash provided by investing activities | 13,836,162 | 14,520,034 |
| Cash flows from financing activities: | | |
| Purchases of office furnishings and equipment | - | (191) |
| Net cash used for financing activities | - | (191) |
| Net change in cash | (245,457) | 293,903 |
| Cash at beginning of year | 315,415 | 21,512 |
| Cash at end of year | \$ 69,958 | 315,415 |

(continued)

The Pennsylvania Higher Education Foundation, Inc.
Consolidated Statements of Cash Flows
For the years ended May 31



| | 2010 | 2009 |
|---|------------------------|---------------------|
| Reconciliation of change in net assets to net cash used for operating activities: | | |
| Change in net assets | \$ (10,396,831) | (22,127,474) |
| Adjustments to reconcile changes in net assets to net cash used for operating activities: | | |
| Gain on sale of fixed asset | (11,015) | - |
| Depreciation | 5,333 | 7,294 |
| Loss from write off of contributions receivable | - | 1,500,000 |
| Net unrealized losses on long-term investments retained | 238,605 | 1,483,407 |
| Net realized (gains) losses on sales of long-term investments | (181,644) | 607,092 |
| Decrease (increase) in investment income receivable | 70,180 | (9,896) |
| Decrease in contributions receivable, net of discount | 1,300,000 | 977,440 |
| Decrease in prepaid expenses | 4,440 | 8,326 |
| Decrease in accounts receivable | - | 48 |
| Increase in accrued expenses | 17,076 | 39,186 |
| (Decrease) increase in grants payable | (5,036,200) | 3,288,637 |
| (Decrease) in amounts payable to specific organizations as designated by donors | (91,563) | - |
| Net cash used for operating activities | <u>\$ (14,081,619)</u> | <u>(14,225,940)</u> |

See accompanying notes to consolidated financial statements.



1. Organization and Operation

The Pennsylvania Higher Education Foundation, Inc. ("PHEF" or the "Foundation"), a not-for-profit organization, was formed on June 22, 2001. Its charitable purposes include, but are not limited to, activities intended to improve or enhance postsecondary educational opportunities for students in Pennsylvania and elsewhere. It may fulfill its purposes by assisting students in meeting their expenses of higher education by providing assistance in the form of grants, loans, or scholarships. It may also enable educational institutions that offer postsecondary programs and lenders to make loans or other financial assistance available to students and parents for postsecondary educational purposes and by providing such other assistance to students, parents, and educational institutions as will improve or enhance postsecondary educational opportunities.

Pennsylvania Higher Education Assistance Agency ("PHEAA"), a discretely presented component unit of the Commonwealth of Pennsylvania, supported the formation of the Foundation and paid for the costs of creating the Foundation. The Foundation is tax-exempt under Section 501(c)(3) of the Internal Revenue Code.

2. Related Entity and Related Party Transactions

A majority of the directors of the Foundation are also members of PHEAA's Executive Committee. As such, transactions between PHEAA and the Foundation are related party transactions.

During the year ended May 31, 2009, the Foundation board of directors adopted a resolution to transfer \$3,000,000 to PHEAA to be used to purchase student loans in the Interim Loan Program for Nursing Students; the transfer was completed in June 2009, and expensed as a grant in the Foundation financial statements. This program assists students going to nursing school by providing a private PHEAA loan, mirroring Stafford loan limits, until the nursing school receives Title IV loan eligibility. The Foundation had previously agreed to guarantee these loans up to \$2,000,000. This resolution extended another \$1,000,000 for this program, and authorized the funding for the full \$3,000,000 grant.

During the years ended May 31, 2010 and 2009, PHEAA provided donated services to the Foundation valued at \$179,428 and \$395,219, respectively. The donated services that PHEAA provided to the Foundation were valued at PHEAA's actual cost and reported as contribution revenue and expenses in the financial statements. All support provided by PHEAA is classified as temporarily restricted gifts since the donations are restricted to PHEAA's statutory purpose.

3. Future Plan and Actions

It is the intention of the Foundation to continue to provide grant awards for as long as funds remain available to do so. As of the date of this report, the Foundation anticipates that sufficient funds will be available to award grants through the May 31, 2011 fiscal year. While the anticipated awards in 2010-11 are expected to be less than 2009-10, these awards have not been approved by the Foundation's board and are subject to change. It is the intention of Foundation management and the board to manage the grant awards so that all approved awards can be fully disbursed and administrative expenses can be paid in full. Since the board has full discretion over the amounts awarded, the Foundation does not anticipate a scenario in which approved awards or incurred administrative expenses would remain unpaid due to a lack of funds.



4. Summary of Significant Accounting Policies

(a) Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Accordingly, net assets, revenues, expenses, gains, and losses are classified based on the existence or absence of donor-imposed restrictions, as defined in note 5.

(b) Consolidation

The consolidated financial statements include the accounts of PHEF and The Higher Education Foundation, Inc., ("HEF") a not-for-profit organization. HEF was also formed on June 22, 2001, and its charitable purpose was to operate exclusively for the benefit of PHEF and the directors of PHEF were the directors of HEF. HEF was formed to assist PHEF with fundraising and program administration particularly for projects that may extend beyond Pennsylvania. All significant intercompany transactions and balances are eliminated in consolidation. During the years ended May 31, 2010 and 2009, HEF had no financial transactions. In addition on November 17, 2009, the directors of HEF voted to dissolve the organization effective immediately.

(c) Investments

Investments include equities, fixed income and money market securities and are reported at fair value.

(d) Fair Value Measurements

On June 1, 2008, the Foundation adopted the provisions of FASB Statement No. 157, *Fair Value Measurements*, now ASC 820, *Fair Value Measurements and Disclosures* for fair value measurements of financial assets and financial liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 also establishes a framework for measurement of fair value and expands disclosures about fair value measurements. The adoption of ASC 820 had no impact on the financial statements.

On June 1, 2009, the Foundation was required to apply the provisions of ASC 820 to fair value measurements of nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The adoption of these provisions had no impact on the Foundation.

(e) Fixed Assets

Fixed assets are reported at cost, net of depreciation. Depreciation is calculated on the straight-line method over the estimated useful life of the asset. Estimated useful lives of fixed assets range from 3 to 25 years.

(f) Donor-restricted Contributions

Contributions that are restricted by the donor are reported as increases in temporarily or permanently restricted net assets, depending on the nature of the restrictions. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as temporarily restricted net assets and reclassified to unrestricted net assets in the statement of activities as net assets released from restriction.



(g) Functional Allocation of Expenses

The costs of supporting the programs and other activities have been summarized on a functional basis in the consolidated statements of activities. Expenses have been classified based upon the actual direct expenditures and cost allocations based upon estimates of time spent by Foundation personnel.

(h) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

(i) Reclassification

Certain prior year amounts have been reclassified to conform to current year presentation.

5. Net Assets

The Foundation classifies its net assets into three categories as follows:

- Permanently Restricted – net assets subject to donor-imposed stipulations that the net assets be maintained permanently by the Foundation.
- Temporarily Restricted – net assets resulting from contributions and other inflows of assets whose use is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions pursuant to those stipulations.
- Unrestricted – Net assets that are neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

Net assets at May 31, 2010 and 2009 consist of the following:

| | 2010 | 2009 |
|------------------------------|--------------|------------|
| Unrestricted | \$ 400,747 | 374,437 |
| Temporarily restricted: | | |
| Nursing Education Initiative | 1,914,829 | 3,344,306 |
| PHEAA's statutory purpose | 5,571,405 | 14,565,069 |
| Total temporarily restricted | 7,486,234 | 17,909,375 |
| Total net assets | \$ 7,886,981 | 18,283,812 |

The Foundation created the Nursing Education Initiative to provide a new source of financial support to schools and students. The intent of the program is to encourage additional students to pursue nursing as an academic and professional choice. PHEAA's statutory purpose is to improve the higher education opportunities for Pennsylvanians.



6. Tax Status

The Internal Revenue Service (“IRS”) has determined and informed the Foundation by a letter dated August 8, 2001 that the Foundation is exempt from federal income tax under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(3). The initial determination of the Foundation’s tax status was to expire on May 31, 2006; however, by letter dated September 30, 2005, the IRS issued a final determination confirming the Foundation’s status as a publicly supported organization.

Effective June 1, 2009, the Foundation adopted former FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, now included in ASC 740, *Income Taxes*. The adoption of ASC 740 has not had a material impact on the financial statements. The Foundation’s accounting policy for evaluating uncertain tax positions is to recognize the effect of income tax positions only if such positions are probable of being sustained.

In March 2010, we received notice from the Internal Revenue Service (IRS) of their plan to conduct an examination of the Form 990 submitted for the May 31, 2008 tax year. Since the initial request for information and a site visit by the IRS, the Foundation responded to two additional requests for information. Subsequent to year end, we received a letter from the IRS indicating that the organization continues to qualify for exemption from federal income tax, and accordingly our Form 990 return has been accepted as filed for the year examined.

7. Investments and Investment Income

Investments at May 31, 2010 and 2009 were as follows:

| | 2010 | 2009 |
|-------------------------------------|---------------------|-------------------|
| Short-term: | | |
| Savings accounts | \$ 177,938 | 277,123 |
| Long-term: | | |
| Fixed income funds: | | |
| US treasury bonds | 2,149,728 | 2,753,767 |
| Government agency bonds | 1,820,718 | 10,692,917 |
| Corporate bonds | 1,509,871 | 1,141,060 |
| Mutual funds | 902,400 | 954,246 |
| Collateralized mortgage obligations | 696,960 | 906,432 |
| Cash and money market securities | 449,323 | 4,933,681 |
| | <u>7,529,000</u> | <u>21,382,103</u> |
| | <u>\$ 7,706,938</u> | <u>21,659,226</u> |



Investment income for the years ended May 31, 2010 and 2009 were as follows:

| | 2010 | 2009 |
|--------------------------------------|-------------------|--------------------|
| Short-term: | | |
| Interest | \$ 821 | 3,415 |
| Long-term: | | |
| Interest and dividends | 381,907 | 900,393 |
| Net unrealized and realized (losses) | (56,962) | (2,090,499) |
| | <u>324,945</u> | <u>(1,190,106)</u> |
| | <u>\$ 325,766</u> | <u>(1,186,691)</u> |

8. Fair Value Measurements

The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date assuming the transaction occurs in the entity's principle (or most advantageous) market.

The fair values of the Foundation's financial instruments represent management's best estimates of the amounts that would be received to sell those assets or that would be paid to transfer those liabilities in an orderly transaction between market participants at that date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Foundation's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Foundation based on the best information available in the circumstances.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

- Cash, short-term investments, prepaid expenses, accrued expenses, and grants payable: The carrying amounts approximate fair value because of the short maturity of these instruments.
- Contributions receivable: The fair value is determined as the present value of future cash flows discounted at an interest rate that reflects the risks inherent in those cash flows on the date the gift is received.
- Long-term Investments: The fair value of fixed income securities, common stock and equity mutual and other funds are determined using quoted market prices at the reporting date multiplied by the quantity on hand. The carrying amount of money market funds approximates the fair value because of the short maturity of these investments.

A fair value hierarchy is used that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quote prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1: Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt, equity securities, and funds that are traded in an active exchange market.
- Level 2: Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted market prices that are traded less frequently than exchange traded instruments.



- Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the asset or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes private equity and limited partnership interests.

The following tables presents assets and liabilities that are measured at fair value on a recurring basis as of May 31, 2010:

| | Fair Value | Level 1 | Level 2 | Level 3 |
|-------------------------|---------------------|------------------|---------|---------|
| Financial Assets: | | | | |
| Investments: | | | | |
| Fixed income funds | \$ 7,079,677 | 7,079,677 | | |
| Money market securities | 449,323 | 449,323 | | |
| | <u>\$ 7,529,000</u> | <u>7,529,000</u> | - | - |

The following table presents assets and liabilities that are measured at fair value on a recurring basis as of May 31, 2009:

| | Fair Value | Level 1 | Level 2 | Level 3 |
|-------------------------|----------------------|-------------------|---------|---------|
| Financial Assets: | | | | |
| Investments: | | | | |
| Fixed income funds | \$ 16,448,422 | 16,448,422 | | |
| Money market securities | 4,933,681 | 4,933,681 | | |
| | <u>\$ 21,382,103</u> | <u>21,382,103</u> | - | - |

9. Contributions Receivable

Contributions receivable at May 31, 2010 and 2009 consist of the following:

| | 2010 | 2009 |
|---------------------|---------------------|------------------|
| Due within one year | \$ 1,000,000 | 2,300,000 |
| | <u>\$ 1,000,000</u> | <u>2,300,000</u> |

Contributions of unconditional promises to give are recognized as revenue when written agreements are signed or follow-up written confirmations are received. All unconditional promises to give are considered fully collectible; accordingly, no allowance for uncollectible pledges has been recorded. However, during the year ended May 31, 2009, one unconditional promise to give in the amount of \$1,500,000 was revoked by the donor. The \$1,500,000 was written off as uncollectable during the year. For the year ended May 31, 2010, there are no unconditional promises to give that are due beyond one year. In June 2010, the remaining \$1,000,000 in contributions receivable was collected. Subsequent to year end, an unconditional promise to give of \$400,000 was received from a donor. All amounts related to this promise have been received and will be used to fund grant awards for two programs.



10. Fixed Assets

Fixed assets at May 31, 2010 and 2009 were as follows:

| | 2010 | 2009 |
|----------------------------------|------------------|----------------|
| Office furnishings and equipment | \$ 130,342 | 130,342 |
| Vehicle | - | 41,628 |
| Software | 865 | 865 |
| | <u>131,207</u> | <u>172,835</u> |
| Less accumulated depreciation | (90,491) | (126,786) |
| | <u>\$ 40,716</u> | <u>46,049</u> |

Depreciation expense for the years ended May 31, 2010 and 2009 were \$5,333 and \$7,294, respectively.

11. Agency Transactions

The Foundation receives donations for which the donor is involved in directing the donation to specified organizations that qualify for Foundation programs. Accordingly, these transactions are considered agency transactions, the donated amount is recorded as a liability in the consolidated statement of financial position, and the Foundation does not recognize contribution revenue and will not recognize a program expense when the donations are transferred to the recipients.

Amounts payable to specific organizations as designated by donors at May 31, 2010 and 2009 were as follows:

| | 2010 | 2009 |
|--|-------------|---------------|
| Balance at beginning of period | \$ 91,563 | 91,563 |
| Donations received | - | - |
| Less donations transferred to specific beneficiaries | (91,563) | - |
| Balance at end of period | <u>\$ -</u> | <u>91,563</u> |

For the agency transactions, the Foundation has committed to providing matching funds to donations within the Nursing Assistance Program based on a percentage of the amount donated to the Nursing Education Grant Program. These amounts are recognized as expenses within the consolidated statements of financial position when the recipients have been identified.

12. Defined Contribution Pension Plan

The Foundation had a defined contribution pension plan. The Foundation's contribution was based on a percentage of salary. The pension plan expense for the years ended May 31, 2010 and 2009 were \$0 and \$15,000, respectively. On November 17, 2009, the Board of Directors adopted a resolution terminating the pension plan effective immediately. The plan terminated, and all assets were subsequently distributed to the participant by December 31, 2009 in accordance with the resolution.



13. Commitments and Contingencies

For the 2010-11 program year, the Foundation has received approximately 124 applications and grant proposals that were approved by the Board of Directors on June 15, 2010, and will result in grants related to the Nursing Education Grant Program of approximately \$5,200,000. The Foundation expects that these grants will be paid by May 31, 2011. In addition, the Foundation has committed up to \$750,000 in matching funds for the 2010-11 academic year to encourage other organizations and individuals to provide scholarship funds for nursing students through other various donor component programs within the Pennsylvania Nursing Assistance Programs.

14. Subsequent events

The Foundation evaluated subsequent events through the date the financial statements were available to be issued on September 22, 2010. No subsequent events requiring disclosure were noted other than those discussed earlier in the financial statement footnotes.