

UNIVERSITY *of* HOUSTON SYSTEM

2005-2006 Annual Financial Report



Organizational Data



ADMINISTRATIVE OFFICERS

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*Chancellor, University of
Houston System*

*President, University of
Houston*

Donald J. Foss

*Senior Vice Chancellor for
Academic Affairs*

John M. Rudley

*Vice Chancellor for
Administration and Finance*

Elwyn C. Lee

*Vice Chancellor for Student
Affairs*

Grover S. Campbell

*Vice Chancellor for
Governmental Relations*

Donald L. Birx

Vice Chancellor for Research

Michael D. Rierson

*Vice Chancellor for University
Advancement*

Dona G. Hamilton

*Vice Chancellor for Legal Affairs
and General Counsel*

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OFFICERS OF THE BOARD (FISCAL YEAR 2006)

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President, University of Houston Clear Lake

Max Castillo

President, University of Houston Downtown

Tim Hudson

President, University of Houston Victoria

Table of Contents

Regents and Executive Officers	inside front cover
Message from the Chancellor	page 1
Message from the Vice Chancellor	page 2
Financial Highlights	pages 3 through 5
Financial Statements	pages 6 through 9
Management's Discussion and Analysis	pages 10 through 17
Notes to the Financial Statements	pages 18 through 25
Financial Staff	inside back cover



We are pleased to present the Annual Financial Report of the University of Houston System for Fiscal Year 2006. The report provides an overview of the System's financial operations and financial position as of August 31, 2006. The University of Houston System, as a public institution, must account fully for the dollars we receive as investments in the educational future of the people of the Upper Gulf Coast and of Texas. This Annual Financial Report is one means of providing assurance of such accountability.

The University of Houston System, with an enrollment of more than 56,000 students, is the state's only metropolitan higher-education system. We comprise four universities and two multi-institution teaching centers: the University of Houston, the University of Houston–Clear Lake, the University of Houston–Downtown, the University of

Houston–Victoria, the University of Houston System at Cinco Ranch, and the University of Houston System at Sugar Land. The four System universities collaborate to offer courses leading to baccalaureate and master's degree programs at the two System centers.

Each of the institutions within the UH System is unique in its mission and in the communities it serves. As a group, the System universities offer a full range of outstanding educational opportunities to the people of the Texas Upper Gulf Coast Region.

The University of Houston System has a remarkable past filled with great achievements. Men and women from around the world continue to receive rigorous educations thanks to the outstanding support of our System family, community partners, and governmental leaders.



*Jay Gogue
Chancellor,
University of Houston
System*



It is my pleasure to present the Annual Financial Report of the University of Houston System. This report illustrates the financial position of the System as of August 31, 2006.

The UH System combines the strengths of four unique and individual campuses: the University of Houston, the University of Houston–Clear Lake, the University of Houston–Downtown and the University of Houston–Victoria.

A priority of the UH System universities is to meet the needs of their diverse student populations in the gulf coast region and Texas. In Fall 2006, the UH System's student enrollment was 56,151 – UH recorded an enrollment of 34,344; UH–Clear Lake reported 7,706; UH–Downtown's enrollment was 11,449; and UH–Victoria was at 2,652.

In FY2006 the UH System unveiled a number of award winning projects and developed new framework plans that provide exciting new visions to meet the System's Strategic Plan. At the University of Houston the M. D. Anderson Library and Honors College, the expansion/renovation project was dedicated, and the Cynthia Woods Mitchell Center for the Arts addition to the Wortham Theater opened. In the spring UH dedicated the new Welcome Center including a parking garage, Academic Services Center and new retail outlets. At UH–Downtown work continued on a parking garage and a new classroom office building for the School of Business, a complex scheduled to open in July 2007. At UH–Clear Lake renovation work to update and enhance the Bayou Building continues. During the year, the UH System's commitment to excellence was recognized as each of these building projects received honors, awards

and publicity for their quality and design.

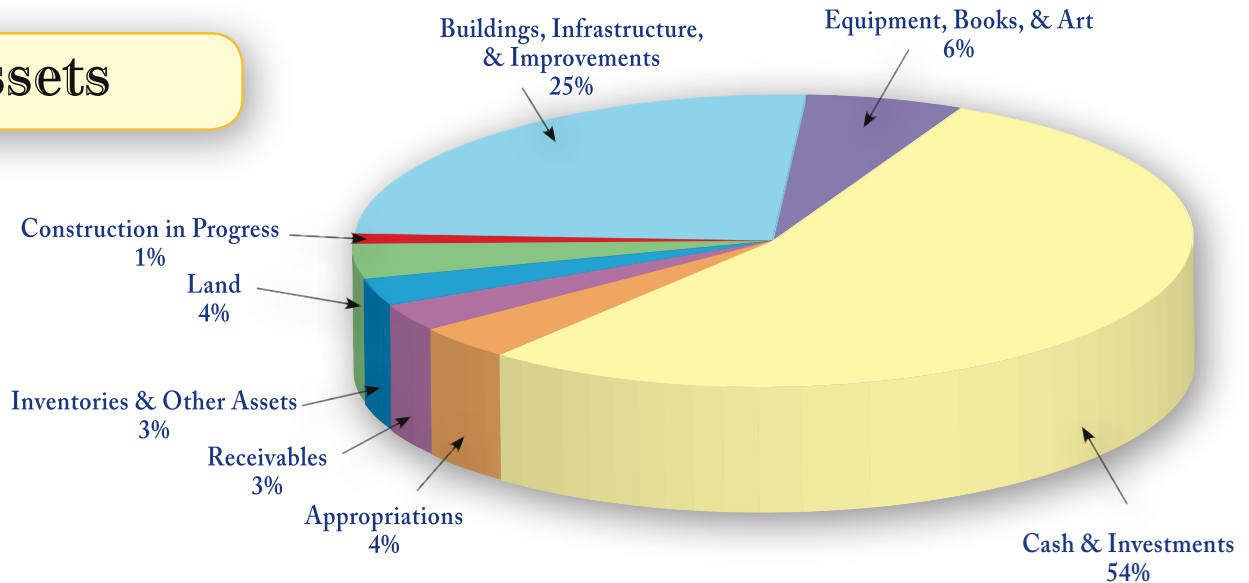
Work also began on several additional new projects. New framework and master plans were developed for UH and UHS at Sugar Land. Design continued on UH–Victoria's new \$35 million classroom building in Sugar Land, a complex to be used jointly with Wharton County Junior College when it opens in 2008. Design also began on a mixed use professional housing complex at UH as the first project to implement the new University Framework plan.

Diversity best describes the areas of research at the University of Houston in Fiscal Year 2006. Most of the campus' research programs were in one of these four areas: bio-med sciences, community advancement, materials, and complex systems. Research programs at UH–Clear Lake are primarily in education and scholarships as well as teacher training. UH–Downtown research programs continue to focus on educational outreach for the success of minority students.

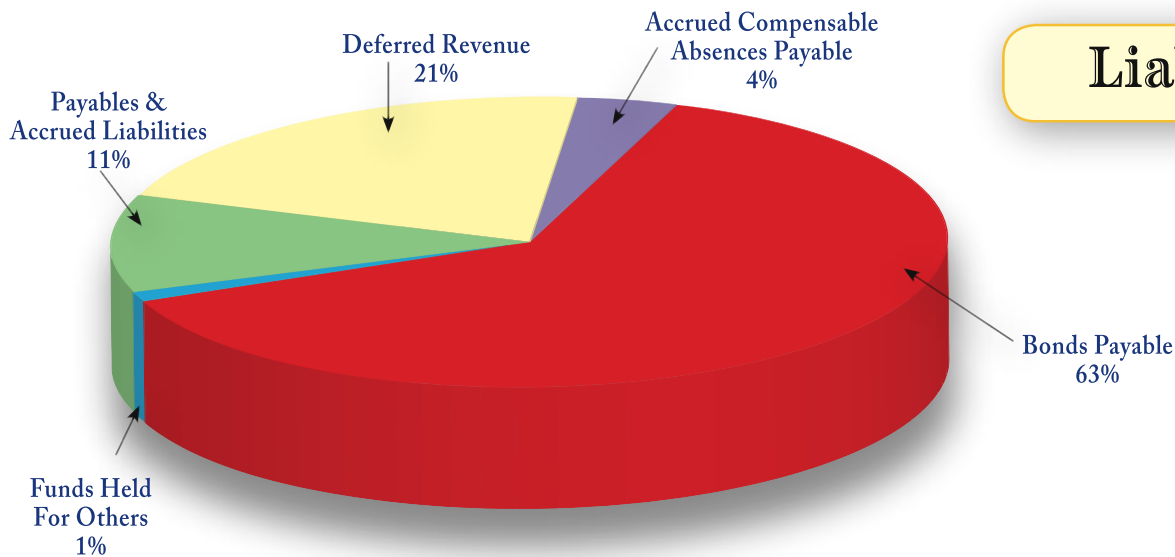
As our financial report illustrates, UH System management understands it is our responsibility to be efficient and effective as we utilize the System's financial resources. We continue to adapt in a rapidly changing and unpredictable economy in the pursuit of our mission, which is to provide a growing, multi-cultural student body with the skills that will serve them for a lifetime.

*John M. Rudley
Vice Chancellor for Administration and Finance*

Assets



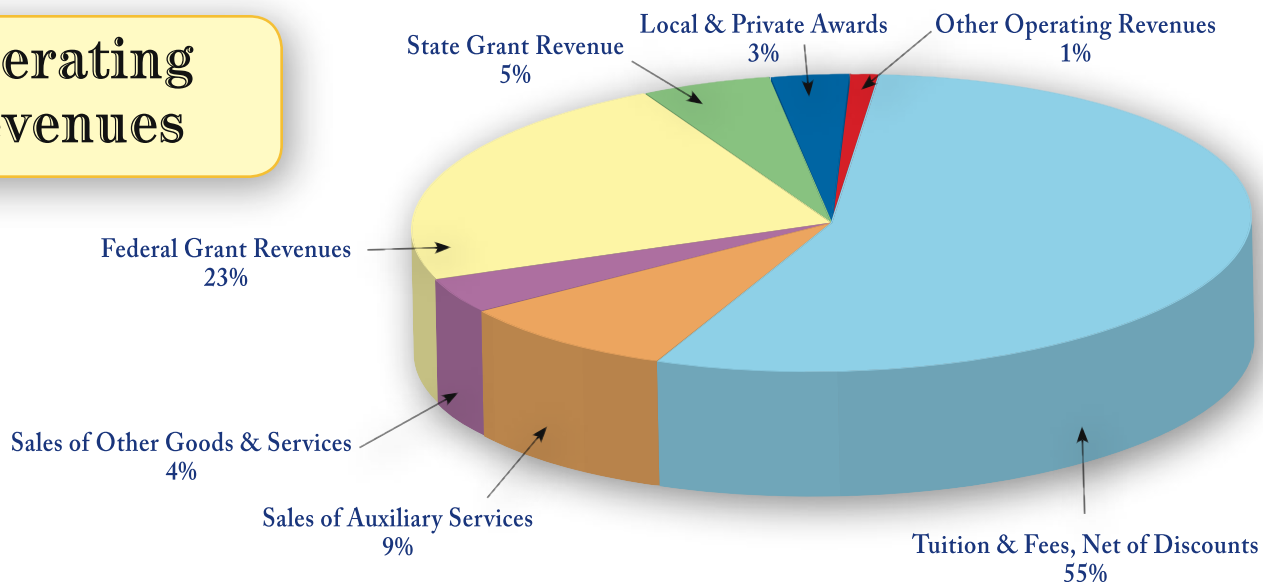
	2006	%	Rounded (To Millions)
Cash and Investments	\$ 794,171,163	54%	\$ 794.2
Appropriations	58,036,786	4%	58.0
Receivables	51,058,288	3%	51.1
Inventories & Other Assets	40,339,618	3%	40.3
Land	60,815,362	4%	60.8
Construction in Progress	17,713,502	1%	17.7
Building, Infrastructure, & Improvements	364,862,476	25%	364.9
Equipment, Books, and Art	95,997,753	6%	96.0
Total Assets	\$ 1,482,994,948	100%	\$ 1,483.0



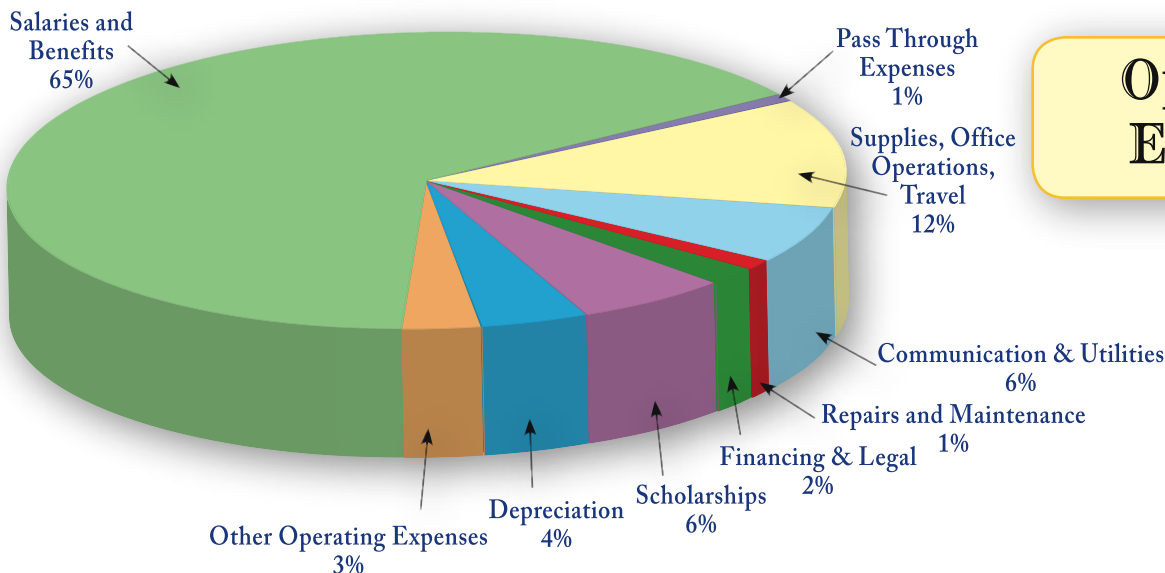
Liabilities

	2006	%	Rounded (To Millions)
Payables and Accrued Liabilities	\$ 51,582,740	11%	\$ 51.6
Deferred Revenue	112,086,608	21%	112.0
Accrued Compensable Absences Payable	18,667,922	4%	18.7
Bonds Payable	332,115,835	63%	332.1
Funds Held For Others	6,294,292	1%	6.3
Total Liabilities	\$ 520,747,397	100%	\$ 520.7

Operating Revenues

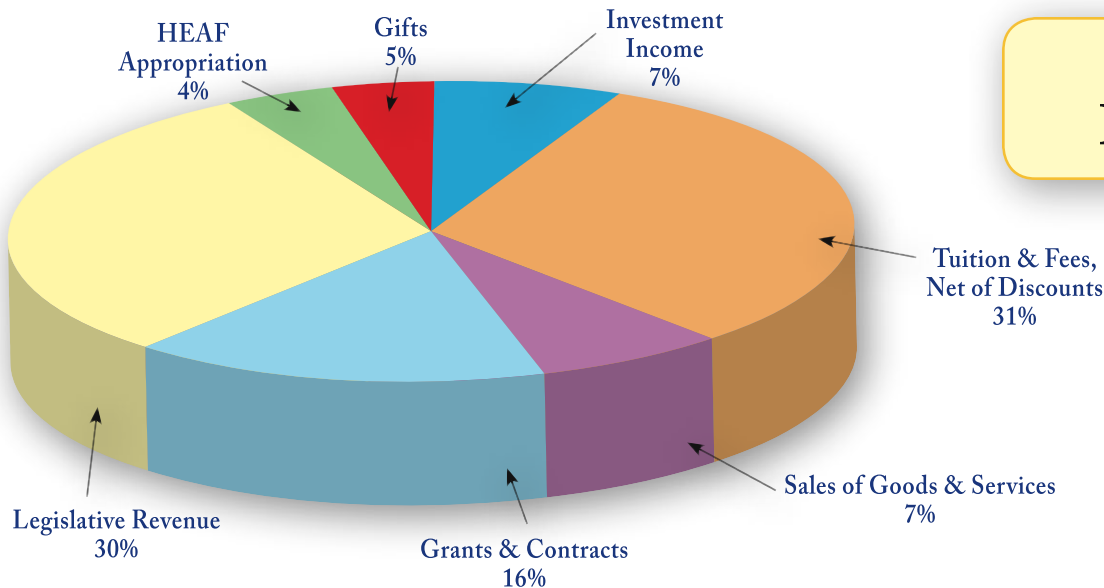


	2006	%	Rounded (To Millions)
Tuition and Fees, Net of Discounts	\$ 255,872,144	55%	\$ 255.9
Sales of Auxiliary Services	38,780,013	9%	38.8
Sales of Other Goods and Services	18,747,353	4%	18.7
Federal Grant Revenues	101,323,878	23%	101.3
State Grant Revenue	22,012,665	5%	22.0
Local and Private Awards	15,176,424	3%	15.2
Other Operating Revenues	1,691,227	1%	1.7
Total Operating Revenues	\$ 453,603,704	100%	\$ 453.6

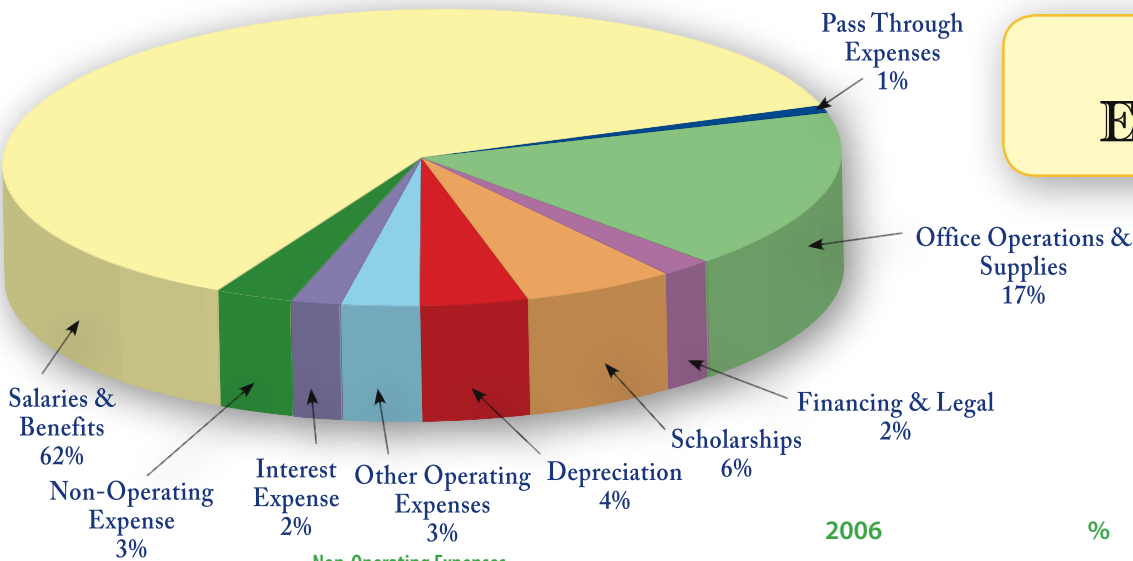


Operating Expenses

	2006	%	Rounded (To Millions)
Salaries and Benefits	\$ 485,027,448	.65%	\$ 485.0
Pass Through Expenses	6,718,171	1%	6.7
Supplies, Office Operations, Travel	87,762,529	12%	87.8
Communication and Utilities	44,973,004	6%	45.0
Repairs and Maintenance	8,198,156	1%	8.2
Financing and Legal	15,579,597	2%	15.6
Scholarships	46,990,414	6%	47.0
Depreciation	27,648,020	4%	27.6
Other Operating Expenses	19,997,492	3%	20.0
Total Operating Expenses	\$ 742,894,831	100%	\$ 742.9



	2006	%	Rounded (To Millions)
Operating Revenue			
Tuition and Fees, Net of Discounts	\$ 255,872,144	31%	\$ 255.9
Sales of Goods and Services	59,218,593	7%	57.5
Grants and Contracts	138,512,967	16%	140.2
Non-Operating Revenue			
Legislative Revenue	247,376,430	30%	247.4
HEAF Appropriation	35,459,008	4%	35.5
Gifts	42,506,659	5%	42.5
Investment Income	56,607,878	7%	56.6
Total Revenues	\$ 835,553,679	100%	\$ 835.6



	2006	%	Rounded (To Millions)
Non-Operating Expenses			
Interest Expense	\$ 13,805,066	2%	\$ 13.8
Other Non-Operating Expense	27,379,208	3%	27.4
Operating Expenses			
Salaries and Benefits	485,027,449	62%	485.0
Pass Through Expenses	6,718,171	1%	6.7
Office Operations & Utilities	140,933,689	17%	140.9
Financing and Legal	15,579,597	2%	15.6
Scholarships	46,990,414	6%	47.0
Depreciation	27,648,020	4%	27.7
Other Operating Expenses	19,997,492	3%	20.0
Total Expenses	\$ 784,079,106	100%	\$ 784.1

University of Houston System

STATEMENT OF NET ASSETS

August 31, 2006

2006

2005

Assets

Current Assets

Cash and Cash Equivalents	\$ 141,117,184	\$ 153,034,571
Short-term Investments	44,798,093	45,527,119
Restricted Cash and Cash Equivalents	22,456,286	16,709,450
Restricted Loans and Contracts	8,806,830	7,713,646
Legislative Appropriations	58,036,786	60,657,587
Receivables	51,058,287	46,776,462
Inventories	2,350,422	3,127,060
Loans and Contracts, Other Assets	18,725,512	26,784,182

Total Current Assets	347,349,400	360,330,077
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Non-Current Assets

Restricted Cash and Cash Equivalents	21,604,508	21,362,140
Restricted Loans and Contracts	10,456,854	10,845,693
Investments	564,195,092	502,687,397
Capital Assets, Non-Depreciable	81,063,103	196,928,490
Capital Assets, Depreciable	1,127,695,432	956,657,815
Accumulated Depreciation	(669,369,441)	(644,857,506)

Total Noncurrent Assets	1,135,645,548	1,043,624,029
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TOTAL ASSETS	1,482,994,948	1,403,954,106
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Liabilities

Current Liabilities

Payables	51,517,595	56,264,626
Deferred Revenues	112,086,608	104,713,090
Notes Payable	65,145	0
Employees' Compensable Leave	8,592,090	7,958,974
Revenue Bonds Payable	18,932,739	15,317,326
Funds Held for Others	6,294,292	6,824,139

Total Current Liabilities	197,488,469	191,078,155
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Noncurrent Liabilities

Employees' Compensable Leave	10,075,832	9,343,144
Revenue Bonds Payable	313,183,096	292,759,831

Total Noncurrent Liabilities	323,258,928	302,102,975
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TOTAL LIABILITIES	520,747,397	493,181,130
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Net Assets

Invested in Capital Assets, Net of Related Debt	254,154,181	240,934,812
Restricted, Debt Retirement	27,622	15,614
Restricted, Capital Projects	671,027	2,587,719
Restricted, Other	75,390,078	66,821,937
Nonexpendable, Endowment Funds	318,314,783	275,937,639
Unrestricted	313,689,860	324,475,255

TOTAL NET ASSETS	\$ 962,247,551	\$ 910,772,976
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University of Houston System

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

For The Year Ended August 31, 2006

	2006	2005
Operating Revenues		
Tuition and Fees, Net of Discounts	\$ 255,872,144	\$ 242,601,245
Sales of Goods and Services	59,218,593	59,061,694
Federal Revenue	101,323,878	96,245,281
State Grant Revenue	22,012,665	23,991,479
Other Grants and Contracts	15,176,424	14,794,647
Total Operating Revenues	453,603,704	436,694,346
Operating Expenses		
Instruction	241,490,359	223,361,447
Research	75,564,069	80,264,517
Public Service	34,032,798	29,221,974
Academic Support	102,961,682	95,763,538
Student Services	29,781,643	28,977,972
Institutional Support	70,531,035	66,828,278
Operation and Maintenance of Plant	53,218,634	48,239,562
Scholarships and Fellowships	44,651,057	44,602,503
Auxiliary Enterprises	63,015,534	63,131,196
Depreciation and Amortization	27,648,020	29,893,107
Total Operating Expenses	742,894,831	710,284,094
Operating Income (Loss)	(289,291,127)	(273,589,748)
Nonoperating Revenues (Expenses)		
Legislative Revenue	250,342,035	230,016,173
Gifts	32,559,488	29,638,899
Investment Income	56,607,878	58,445,720
Interest Expense and Fiscal Charges	(13,805,066)	(12,981,015)
Gain (Loss) on Sale of Capital Assets	0	(3,985)
Other Nonoperating Revenues (Expenses)	(27,379,208)	(34,249,769)
Total Nonoperating Revenues (Expenses)	298,325,127	270,866,023
Income (Loss) Before Other Revenues, Expenses, Gains, Losses and Transfers	9,034,002	(2,723,725)
Other Revenues, Expenses, Gains, Losses and Transfers		
Capital Appropriation (Higher Education Assistance Funds)	35,459,008	36,952,989
Additions to Permanent and Term Endowments	9,947,173	8,992,022
Transfers	(1,747,726)	4,329,654
Legislative Appropriations Lapsed	(1,217,880)	(265,307)
Total Other Revenues, Expenses, Gains, Losses and Transfers	42,440,573	50,009,358
Change In Net Assets	51,474,575	47,285,633
Net Assets Beginning	910,772,976	906,150,265
Restatements	0	(42,662,922)
Net Assets Beginning, as Restated	910,772,976	863,487,343
Net Assets, Ending	\$ 962,247,551	\$ 910,772,976

University of Houston System

STATEMENT OF CASH FLOWS

For The Year Ended August 31, 2006

2006

2005

Cash Flows from Operating Activities

Proceeds Received from Students and Customers	\$ 308,588,844	\$ 281,635,487
Proceeds from Loan Programs	8,305,808	7,289,693
Proceeds from Other Revenues	171,427,038	170,096,244
Payments to Suppliers for Goods and Services	(164,425,163)	(173,013,124)
Payments to Employees	(482,437,381)	(459,376,640)
Payments for Loans Provided	(9,020,096)	(7,786,599)
Payments for Other Expenses	(82,044,671)	(81,795,373)

Net Cash Provided (Used) by Operating Activities (249,605,621) (262,950,312)

Cash Flows from Noncapital Financing Activities

Proceeds from State Appropriations	249,448,391	220,219,380
Proceeds from Gifts	37,943,694	31,174,998
Proceeds from Endowments	27,846,837	27,689,522
Proceeds from Transfers from Other Funds	21,927,402	21,537,470
Proceeds from Other Revenues	180,469	4,003,177
Payments for Other Uses	(75,093,441)	(115,289,023)

Net Cash Provided by Noncapital Financing Activities 262,253,352 189,335,524

Cash Flows from Capital and Related Financing Activities

Proceeds from Disposal of Capital Assets	0	3,000
Proceeds from Capital Financing Activities	73,370,843	95,816,238
Payments for Additions to Capital Assets	(60,345,150)	(71,959,795)
Payments of Principal and Interest on Debt Issuance	(31,277,717)	(27,591,108)

Net Cash Used by Capital and Related Financing Activities . . (18,252,024) (3,731,665)

Cash Flows from Investing Activities

Proceeds from Interest and Investment Income	102,477,660	107,348,085
Payments to Acquire Investments	(102,801,550)	(21,527,142)

Net Cash Provided by Investing Activities (323,890) 85,820,943

Increase (Decrease) in Cash and Cash Equivalents	(5,928,183)	8,474,490
Cash and Cash Equivalents, September 1	191,106,161	182,631,672
Restatements to Beginning Cash and Cash Equivalents	0	0
Cash and Cash Equivalents, August 31	185,177,978	191,106,161

Reconciliation of Operating Income (Loss) to Net Cash Provided (Used) by Operating Activities

Operating Income (Loss)	(289,291,127)	(273,589,748)
Adjustments to Reconcile Operating Income to Net Cash Provided (Used) by Operating Activities		
Amortization and Depreciation	27,648,020	29,893,107
Changes in Assets and Liabilities		
(Increase) Decrease in Receivables	18,519,383	10,287,394
(Increase) Decrease in Inventories	776,638	(166,246)
(Increase) Decrease in Loans and Contracts	(714,288)	(496,907)
(Increase) Decrease in Other Assets	7,909	(58,428)
(Increase) Decrease in Prepaid Expenses	8,058,669	(6,091,058)
Increase (Decrease) in Payables	(25,069,174)	(29,501,310)
Increase (Decrease) in Deferred Income	7,373,518	4,308,791
Increase (Decrease) in Other Liabilities	3,084,832	2,464,093

Total Adjustments 39,685,507 10,639,436

Net Cash Provided (Used) by Operating Activities \$ (249,605,621) \$ (262,950,312)

University of Houston System

SCHEDULE OF OPERATING EXPENSES

For The Year Ended August 31, 2006

2006

2005

Expenses by Natural Classification

Cost of Goods Sold	\$ 1,902,807	\$ 1,686,106
Salaries and Wages	398,149,895	373,956,755
Payroll Related Costs	86,877,553	81,867,400
Professional Fees and Services	35,679,637	34,080,675
Federal Pass-Through Expenses	6,513,763	8,208,484
State Pass-Through Expenses	204,407	55,110
Travel	11,982,919	10,486,556
Materials and Supplies	33,843,216	39,507,455
Communication and Utilities	44,973,004	37,224,356
Repairs and Maintenance	8,198,156	8,644,904
Rentals and Leases	11,987,968	12,018,879
Printing and Reproduction	4,353,950	4,586,358
Depreciation and Amortization	27,648,020	29,893,107
Interest	2,341,330	2,439,443
Scholarships	46,990,414	44,853,239
Claims and Losses	1,250,300	1,545,533
Other Operating Expenses	19,997,492	19,229,734
TOTAL OPERATING EXPENSES	742,894,831	710,284,094

Expenses by Functional Classification

Instruction	241,490,359	223,361,447
Research	75,564,069	80,264,517
Public Service	34,032,798	29,221,974
Academic Support	102,961,682	95,763,538
Student Services	29,781,643	28,977,972
Institutional Support	70,531,035	66,828,278
Operation & Maintenance of Plant	53,218,634	48,239,562
Scholarships & Fellowships	44,651,057	44,602,503
Auxillary Enterprises	63,015,534	63,131,196
Depreciation & Amortization	27,648,020	29,893,107
TOTAL EXPENSES BY		
EXPENDITURE FUNCTION	\$ 742,894,831	\$ 710,284,094

University of Houston System

MANAGEMENT'S DISCUSSION AND ANALYSIS



INTRODUCTION

The following Management's Discussion and Analysis section of the University of Houston System's Annual Financial Report has been prepared to provide an overview of the activities and the financial position of the University of Houston System for the fiscal year ended August 31, 2006. This presentation is intended to offer a summary of significant current year activities, resulting changes, and currently known economic conditions and facts. This analysis should be read in conjunction with the System's basic financial statements and the notes to the statements.

BACKGROUND

The University of Houston System (UHS) serves the nation's fourth largest metropolitan area and the upper Texas Gulf Coast, and is part of the state-supported system of higher education in Texas. The System is comprised of four universities and a supporting System Administration. The four universities are University of Houston (UH), University of Houston – Clear Lake (UHCL), University of Houston – Downtown (UHD), and University of Houston – Victoria (UHV); all of which are located along the Texas Gulf Coast. The System has also established teaching centers that offer instructional opportunities at facilities at the UH System at Sugar Land, and the UH System at Cinco Ranch in Katy. Houston and the upper Gulf Coast region represent approximately one fourth of the state's population and economy. The area is also one of the most

ethnically diverse parts of the state, with UH and UHD two of the most diverse universities nationally.

The mission of the System and its universities is to educate students, create new knowledge, and foster an interactive relationship with the communities served. The System universities are the primary providers of graduate and undergraduate services for Houston and the Upper Texas Gulf Coast region. In recent years, the universities have built multi-disciplinary research programs in areas such as materials science, the biosciences, and the computational sciences, all of which align with major regional and state industries – energy, biotechnology, aerospace, and computers. In doing so, each of the System's universities has created programs of international repute that contribute greatly to the regional and state economies. The System serves over 56,000 students and employs approximately 12,000 individuals.

UH System Distance Education is a partnership of the four institutions of the System. Going beyond the traditional campus boundaries, UH, UHCL, UHD, and UHV cooperate in providing high-quality educational opportunities to the community. This collaboration delivers more than forty degree programs taught by university faculty via face-to-face instruction and electronic technologies at off-campus sites, including UHS at Cinco Ranch, UHS at Sugar Land, selected community college campuses, corporations, and organizations. A number of programs can be pursued completely through videotape and online delivery. All courses are junior, senior, and graduate level and carry all the same workloads, prerequisites, and requirements as on-campus courses. The University of Houston System universities have won national awards in distance education and are a leader among Texas universities in distance education enrollments. UH System Distance Education provides maximum access to higher education opportunities for residents throughout the Gulf Coast region.

OVERVIEW OF THE FINANCIAL STATEMENTS

During the 2002 fiscal year, the State of Texas adopted Governmental Accounting Standards Board (GASB) Statement No. 34, Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments, and Governmental Accounting Standards Board Statement No. 35, Basic Financial Statements – and Management's Discussion and Analysis



– for Public Colleges and Universities. These accounting pronouncements established new reporting requirements including the presentation of new financial information and a restructuring of the presentation of previous fiscal years. Whereas the previous standards focused on the accountability of individual fund groups, the new standards focus on the preparation of financial statements that present aggregate operations. The financial statements for fiscal years 2002 through 2006 have been prepared in accordance with these rules.

The financial statements for the fiscal year ended August 31, 2006 are presented in a significantly different format as compared to years prior to fiscal year 2002. Governmental Accounting Standards Board Statement No. 35 requires the System to include three financial statements in the annual financial report. They are (1) the Statement of Net Assets, (2) the Statement of Revenues, Expenses, and Changes in Net Assets, and (3) the Statement of Cash Flows. The information contained in the consolidated financial statements of the University of Houston System is part of and included in the State of Texas Comprehensive Annual Financial Report. The financial statements of the System are presented for the fiscal year ended August 31, 2006, with financial data for the fiscal year ended August 31, 2005, provided for comparative purposes. Prior year totals have been reclassified, when necessary, to reflect current year changes in reporting procedures and to enhance comparability of reported totals.

The format of the statewide financial statements presents a comprehensive perspective of the state's financial activities. The state's activities are divided into three types for presentation in the primary financial statements. They are Governmental Activities, Business-type Activities, and Component Units. The financial operations of the University of Houston System are considered a business-type activity because the primary activity of the System's component university campuses is the offering of higher

education level instruction. The universities charge a fee, in the form of tuition, to customers in order to pay for a majority of the cost of the services provided. Under this classification, the System's financial statements conform to the guidelines and presentation formats prescribed for Proprietary Funds.

As a result of the adoption of the GASB reporting standards, the System is required to report accumulated depreciation on its capital assets. Additionally, the System recognizes a current year charge for depreciation expense.

Revenues and expenses are classified as either operating or non-operating in the financial statements. Previous reporting standards focused on the accountability of individual fund groups and did not provide a measurement of entity-wide operations. A significant portion of the System's recurring resources are classified as non-operating by GASB Statement No. 35. Substantially all state appropriations are treated as non-operating revenues.

Tuition and fee revenues are reported net of any scholarship discounts and allowances. A scholarship allowance is the difference between the stated charge for services provided by a university and the amount that is paid by the student or third parties making payments on behalf of the student. Funds received to satisfy student tuition and fee charges are reported as revenue only once. Institutional resources provided to students as financial aid are reported as scholarship allowances in amounts up to and equal to amounts owed by the students to the university. This accounting procedure is known as tuition discounting.

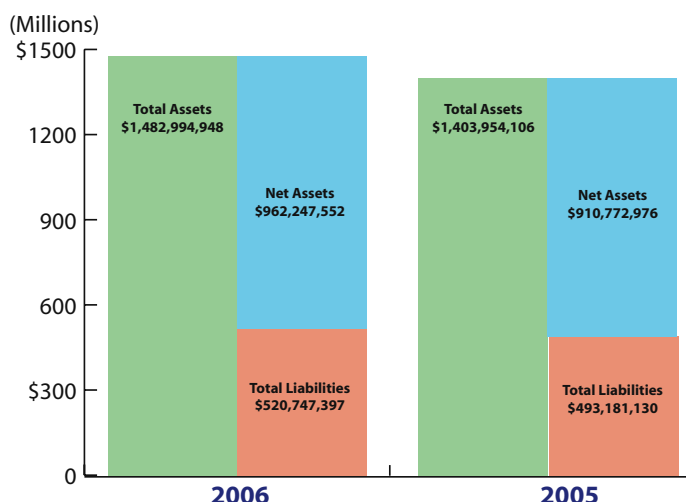


STATEMENT OF NET ASSETS

The first schedule presented is the Statement of Net Assets. The statement reflects the System's assets and liabilities using the full accrual basis of accounting, and represents financial position as of the conclusion of the fiscal year. This is a point in time financial presentation and presents a snapshot view of the financial status as of August 31, 2006. Comparative data for the previous fiscal year has also been presented as of August 31, 2005. Assets and liabilities are presented as either current or noncurrent to provide an indication of their anticipated liquidation. Net Assets is equal to Assets minus Liabilities. Unrestricted Net Assets are available to the System for any lawful purpose. Unrestricted Net Assets often have constraints on resources, which are imposed by management, but can be removed or modified. On August 31, 2006, the University of Houston System's Assets totaled \$1.483 billion, and Liabilities totaled \$521 million, resulting in a Net Asset valuation of \$962 million. This represents an increase in net assets of \$51 million.

The Statement of Net Assets enables the reader of the financial statements to determine the assets available for use in the continuing operations of the institutions. Also, the reader will be able to determine the amounts owed to vendors, investors, and lending institutions. Net Assets are presented in three major categories: invested in capital assets, net of debt; restricted net assets; and unrestricted net assets. The invested in capital assets category identifies

STATEMENT OF NET ASSETS



the equity in property, plant, and equipment owned by the System. Restricted net assets are presented in two sub categories: non-expendable and expendable. Non-expendable restricted net assets are available only for endowed investment purposes. Expendable net assets are available for expenditure but must be expended for the purposes specified by the external donor/provider of the assets. Unrestricted net assets are available for any lawful purpose of the institution. Although not subject to the stipulations of external requirements, a significant portion of the System's unrestricted net assets are committed to various future operating budgets related to academic, research, and capital programs and projects.

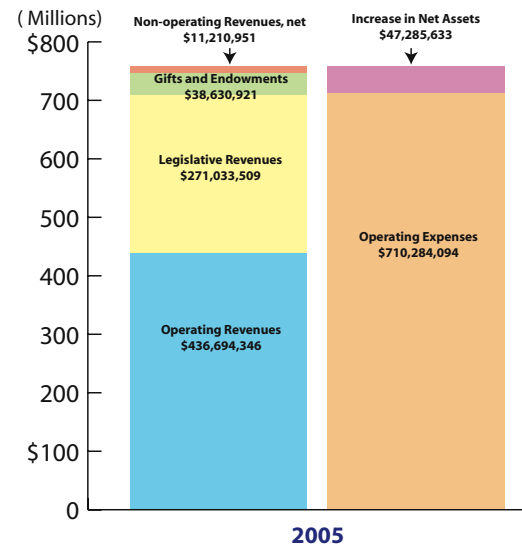
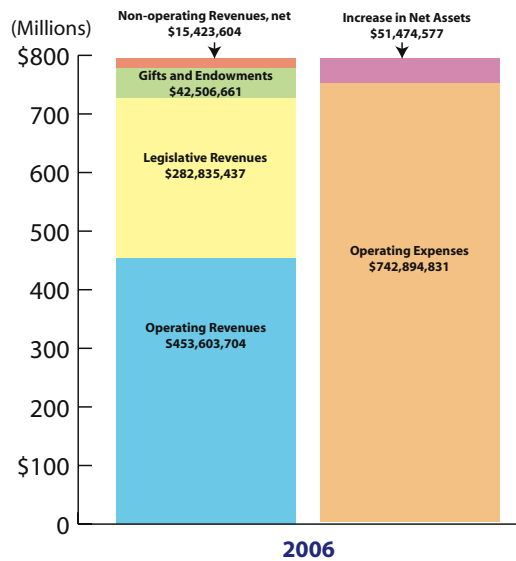
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

The next statement comprising the primary financial statements is the Statement of Revenues, Expenses, and Changes in Net Assets. This schedule identifies operating and nonoperating revenues received by the System. Additionally, both the operating and non-operating expenses incurred by the System during the fiscal year are displayed. Finally, any other gains and losses or other forms of revenue and expense are reported.

During the 2006 fiscal year the System recognized operating revenues of \$454 million and operating expenses of \$743 million. After recognizing non-operating activities and other gains and losses, the System realized a net increase in net assets of \$51 million. During the prior fiscal year, the System experienced an increase in net assets of \$5 million. Additionally, during the prior fiscal year, there was a one-time recognition of prior years' accumulated depreciation.

Operating revenues are received and recognized as a result of providing services to the component universities' customers. Operating expenses are the costs necessary to provide those services and to fulfill the mission of the System. Operating expenses are displayed in the Statement using the functional method of classification. The functional, or programmatic, classification method presents operating expenses in a manner that reflects the System's commitments in fulfilling its mission of instruction, research, and public service, as well as the requirements of supporting and maintaining its administrative and physical structure. Non-operating revenues are those received for which no services are directly provided. State appropriations are classified as non-operating revenue because they are provided by the Legislature to the System without the Legislature directly receiving goods or services for those revenues. As previously mentioned, significant portions of the System's recurring resources are classified as non-operating. Net resources from other than operating revenues totaled \$382 million for fiscal year 2006.

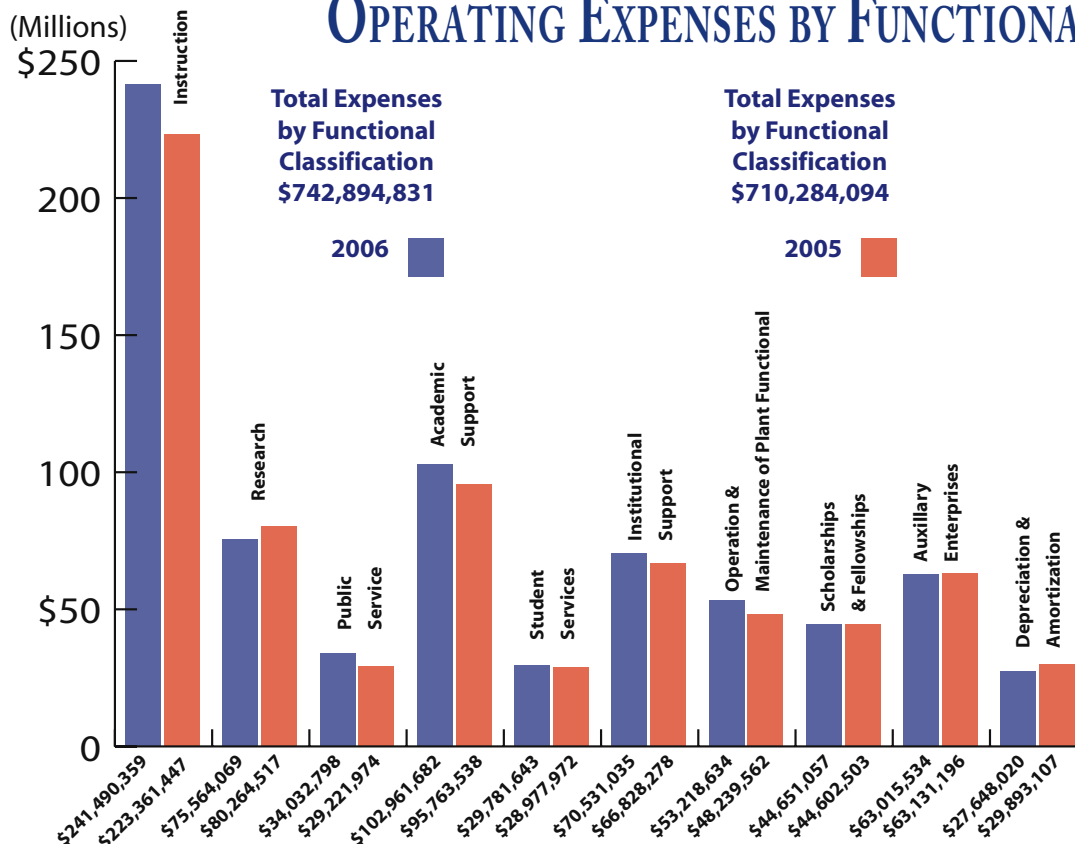
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

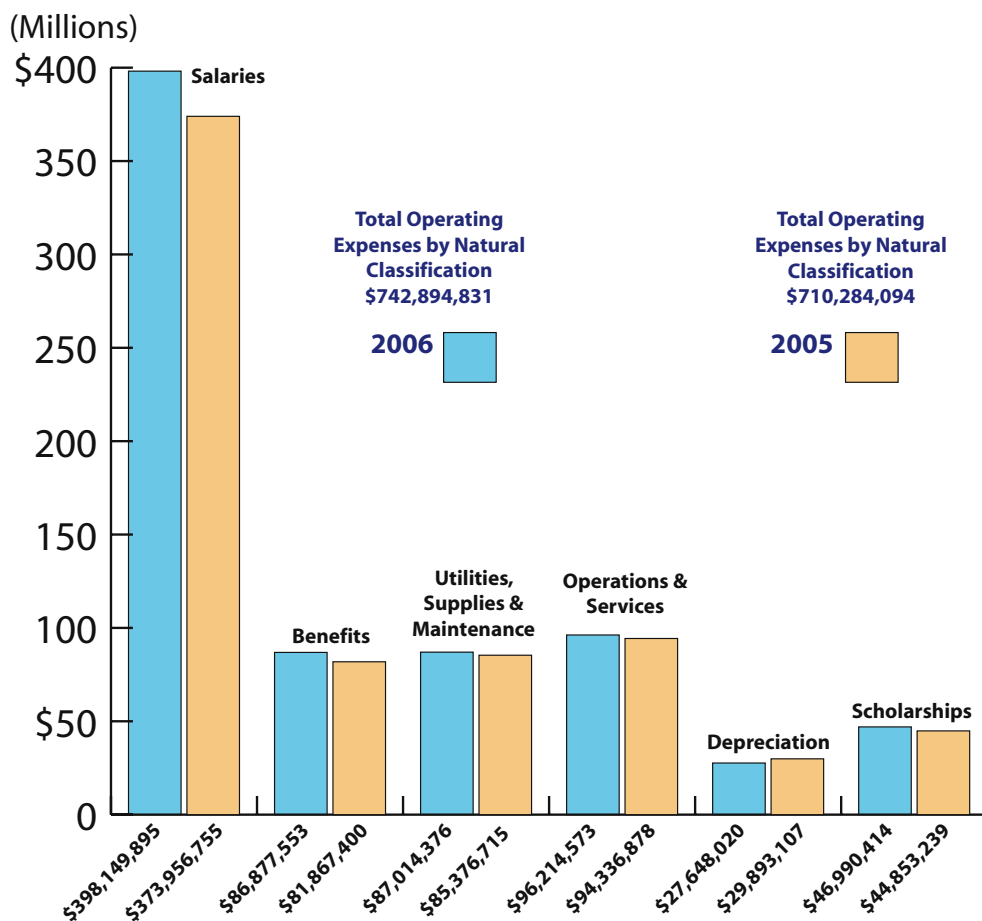


STATEMENT OF CASH FLOWS

The third primary statement included in the financial statements is the Statement of Cash Flows. This schedule explains the change during the fiscal year in cash and cash equivalents, regardless of whether there are restrictions on their use. The Statement of Cash Flows should be used in conjunction with related disclosures and information in the other financial statements. The statement can provide relevant information about an entity, such as the ability to generate future net cash flows, the ability to meet obligations when due, or reasons for differences between operating income and associated cash receipts and payments. The statement is comprised of five sections. The first section recognizes the cash flows from operating activities as well as the net cash used by operating activities. The second section identifies the cash flows from noncapital financing activities. The third section reflects the cash flows from capital and related

OPERATING EXPENSES BY FUNCTIONAL CLASSIFICATION





OPERATING EXPENSES BY NATURAL CLASSIFICATION

financing activities. The next section details the cash flows from investing activities. The final section reconciles net cash used to the operating loss or income reflected on the Statement of Revenues, Expenses, and Changes in Net Assets.

The cash and cash equivalents balance at the conclusion of the 2006 fiscal year totaled \$185 million, which reflected a net decrease in cash of \$6 million.

CAPITAL ASSETS

Critical to maintaining the quality of academic, research, and service programs, as well as residential life, is the development and renewal of the System's capital assets. The System's institutions continue the implementation of their long-range capital plans, with a prudent combination of renovation and modernization of older facilities, along with new construction.

At the end of the 2006 fiscal year, the System had \$539 million of capital assets, net of accumulated depreciation. These assets included land, buildings, infrastructure and improvements, furniture and equipment, library books, and works of art. Several major capital construction projects are in various stages of completion, and the cumulative investment in these assets is reported as construction in progress. Capital assets, net of accumulated depreciation, at August 31, 2005, totaled \$509 million.

Fiscal year 2006 continued the trend of bringing major changes to UH System facilities. At the University of Houston, construction has been completed on the renovation and expansion of the M.D. Anderson Library.

Also completed, is construction on the state-of-the-art Science and Engineering Research and Classroom Complex (SERCC). A four-story, 1,500 parking space garage at UH has been completed. This multi-functional facility also includes a new Welcome Center which provides easier access to student services, and a place to welcome prospective students, their parents, and returning alumni. Construction has been completed on the new Student Services and Classroom Building at the University of Houston – Clear Lake. Having recently completed the Commerce Street Building, a new classroom facility, the University of Houston – Downtown has embarked on another major construction project. A new academic building and parking garage facility will provide critical instructional space and student services for UH students. At the University of Houston – Victoria, construction plans are being implemented for a new academic building in Sugar Land to meet growing demands at the multi-institutional teaching facility. UHV is also designing and developing plans for a Regional Economic Development Building and a Nursing/Allied Health facility. Completion of each of these projects will provide enhanced and significant benefits to the System's students and other

constituencies. The System maintains a goal of improving the physical condition of the campuses, while at the same time, preserving their condition and maximizing their utilization.

DEBT ADMINISTRATION

The System complements the management of its financial resources with the prudent use of debt to finance capital projects. Detailed information concerning the System's long-term debt is found in the notes to the financial statements.

The University of Houston System is authorized by statute to issue long term debt in the form of revenue bonds. Each series of revenue bonds issued is backed by a pledged revenue source specified in the bond resolution. Additionally, each issue is designed to be self supporting from the primary revenue source. At August 31, 2006, the University of Houston System had \$332 million of long term bonded debt outstanding, \$19 million of which will be retired during the 2007 fiscal year.

In fiscal year 2006, the University of Houston System issued \$83.59 million of Consolidated Revenue and Refunding Bonds, Series 2006. Proceeds from this bond issue will be used to finance construction of a new classroom, office building, and parking garage facility at the University of Houston – Downtown, as well as to refund portions of outstanding Consolidated Revenue Bonds, Series 1997 and 2000.

During fiscal year 2007, the System established a commercial paper program that will permit the issuance of commercial paper notes which may not exceed, in the aggregate, the principal amount of \$50 million. It is anticipated that commercial paper will be issued to provide interim financing for the costs of various capital projects within the System.

ECONOMIC OUTLOOK

While it is true that the UH System universities strive to make the most of available funds, the needs of our constituencies and the goals we have established for serving them necessitate greater resources than our universities currently possess. By 2015, demographic forecasts predict the Houston metropolitan area will add another 1.4 million persons, 800,000 of which will be of Hispanic descent. Accommodating a corresponding level of enrollment growth at our universities will require tremendous investments in faculty, staff, facilities and other infrastructure. Therefore, during the 80th Legislative session, which meets during 2007, UHS will ask that the Legislature consider the following items as areas of critical concern to the University of Houston System: (1) increase base funding to support enrollment growth, increasing costs of goods and services, faculty

& staff salaries, and insurance; (2) appropriate increases to Higher Education Funds statutorily authorized during the 79th Texas Legislature, to support enrollment growth, deferred maintenance, fire marshal compliance and other life/safety issues; (3) fully-fund debt service on tuition revenue bonds, so that we may fulfill our obligations on capital projects without diverting resources from other critical priorities including instruction and research; and (4) increase financial aid, especially for the TEXAS Grant program, to enhance student enrollment, retention, and graduation.

In addition to student access, academic and research excellence are critical to fully preparing students for the 21st century workforce and for generating the research needed to fuel economic development in today's economy. This is especially important for the University of Houston main campus as it seeks to become the state's third top-tier research university, more of which are needed in the state and the Houston metropolitan area. Therefore, the UH System will also request that the Texas Legislature consider proposals to fully fund the Research Development Fund as statutorily authorized, to achieve the research and academic excellence goals Texas needs for economic prosperity, and to continue providing funding for special items and new funding for exceptional items, to support an array of valuable research and public service programs and to leverage external resources.

As part of its strategic plan, the University of Houston System also identified accountability and administrative efficiency as one of its strategic principles. Related initiatives on which our universities are working include direct deposits for vendor payments and employee reimbursements, to cut down on the number of paper checks issued, new energy conservation measures, and more inclusive HUB procedures. The UH System will also continue implementing and upgrading its financial, human resources, and student information systems. A major benefit of these new systems will be the availability of accurate, timely, and consistent management information, which is critical to administrative efficiency.

The System is not aware of any known facts or decisions that are expected to have a significant effect on the financial position or results of operations during the 2007 fiscal year. Although it is not possible to predict ultimate results, management believes the University of Houston System's financial condition and position are strong. The System's administrative and management teams realize that universities must be good stewards of the dollars with which they are entrusted. The University of Houston System is committed to this principle. Accomplishing the System's goals and mission is predicated on the effective management of resources, which the University of Houston System strives to achieve.

GROWTH AND EXPANSION FOR THE UNIVERSITY OF HOUSTON SYSTEM

System centers are being developed in high-growth parts of the metropolitan areas and the Texas Medical Center, where there is demonstrated need for our programs.



University of Houston System

As the demands and requirements of our area's population and economic/industrial base increase, the UH System universities must be creative and efficient in the ways we provide educational services given the limited resources available to us. Often, we are better served by working together rather than individually. In 1995, the UH System universities launched the UH System at Sugar Land, where all four of our universities collaborate in offering baccalaureate and master's degrees. By working together, we are able to serve the needs of this burgeoning community efficiently and effectively. In fall 2002, the UH-System Administration opened UHS at Sugar Land, an \$11 million building with 57,000 square feet and over 30 classrooms. Currently, we are working with the Fort Bend County community and Wharton County Junior College to construct a new building that will house programs from both of our institutions. Based on the success of the Sugar Land venture, the UH-System Administration opened the UH System at Cinco Ranch in West Houston. Operating since 2001, the center offers more than 30 undergraduate and master's degree programs to students in the western part of the metropolitan area.

In FY 2005, the UH System and its Board of Regents undertook a strategic planning process to identify a set of strategic principles to guide system planning and decision-making. One of the strategic principles that emerged was a student access initiative, through which we established a goal of increasing enrollment system-wide from 56,000 students to 70,000-75,000 students by 2015. Off-campus teaching centers must serve as a principal way we accomplish this goal. Given our limited resources, and the need to reach more students in high-growth areas where they live and work, off-campus centers constitute the most effective way of proceeding. Currently, new UH

University of Houston

UH has developed a broad Master Plan to serve as a blueprint for growth over the next twenty years. The plan not only provides a physical framework for growth, but it also helps the university realize many of its goals, including increasing the number of undergraduate students living on campus and providing a focus for arts and professional programs.

The framework is under way, and new housing in the Professional District of the campus will begin construction during the spring of 2007. The older science buildings in the Core Academic District are being refurbished, and proposals are being developed for expanding several colleges and programs. Students are benefiting from the goals of the plan today with the opening of the Welcome Center and Parking Garage. Convenient parking, easier access to student services, and a spirited place to welcome prospective students, their parents, and returning alumni are just the beginning of the University of Houston's new planning framework. The expansion of the M.D. Anderson Library, which is nearly twice as large and includes greatly enhanced computer facilities and new student gathering spaces, has been completed. The Science and Engineering Research and Classroom Complex, also recently completed, will house interdisciplinary health and nanotechnology research. Construction plans are under way for the first new housing units. Better access to facilities and adequate parking in the Arts District and the Stadium District will make it easier for friends and Cougar fans to experience UH events.

University of Houston–Clear Lake

The 524-acre UHCL campus, which is adjacent to the Lyndon B. Johnson Space Center and Armand Bayou Nature Center, serves an advanced technology economy by providing undergraduate, graduate, and professional programs for over 7,800 students. Through its strong partnerships with the community, UHCL provides advanced educational programs, innovative training, and research opportunities to the Bay Area region. UHCL is providing leadership in advancing a new era of interactive and technological access and instruction through its instructional technology and distance education initiatives. The university now offers three academic programs completely online and has off-campus face-to-face programs at ten different locations including the UHS' multi-institution teaching centers in Sugar Land and Cinco Ranch in Katy.



UHCL's natural landscape provides refuge from nearby urban centers. Bayous, parks, and scenic trails wind through the wooded campus that surrounds the university's five main buildings. Student life is enhanced by a variety of recreational facilities, as well as residential life facilities. Construction has recently been completed on a new Student Services and Classroom Building. This new addition will enable UHCL to better provide opportunities and services to the campus community.

University of Houston– Downtown

The University of Houston – Downtown is a public, urban university committed to providing quality academic programs that serve the needs of the multicultural population of Houston and surrounding communities. It offers both undergraduate and a limited number of graduate academic degree programs that enable students to acquire the knowledge and skills needed to succeed in their chosen fields. UHD's open admissions policies provide educational access for students from a wide variety of backgrounds. UHD remains the most ethnically diverse university in the state.

The campus is located in the heart of the city, in downtown Houston. The university is only blocks from the central business district where numerous corporations have their headquarters. Sports, theater, and fine arts facilities and venues are all located conveniently to the campus. UHD is conveniently accessible, and METRO's light rail line stops at the university's Main Street entrance. The university continues to enhance the opportunities available to students, faculty, and staff through the construction of additional facilities. The Commerce Street Building, a new classroom facility, has been recently completed. Additionally construction was started during the fiscal year on a new academic building and parking garage facility. Completion of this project will assist in relieving a critical space deficit, particularly in instructional space, and make a contribution to future growth needs.

University of Houston– Victoria

University of Houston – Victoria is an upper-level and graduate institution with selected bachelor's and master's degree programs in the arts and sciences, business administration, and education and human development. UHV serves commuting students from Victoria and surrounding counties; offers degree programs, in collaboration with other UH System institutions, at two off-campus centers in Fort Bend County; offers courses at a number of other off-campus sites in the region; and offers courses and programs via the Internet. The university is continually expanding its programs to meet the needs of the service region.

Delivery of courses to off-campus centers and online has enabled the institution to expand its range and better serve the public. Design and construction plans are under way for a new academic building in Sugar Land to meet demand in that rapidly growing area. Additionally two projects have been slated in the Victoria community. One of these will be a Regional Economic Development Building, and the other planned project is a Nursing/Allied Health facility.



University of Houston System

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED AUGUST 31, 2006



General Introduction

The State Auditor of Texas has not audited the accompanying Annual Financial Report and, therefore, an opinion has not been, nor will be expressed on the financial statements and related information contained in this report. The information contained in the combined financial statements of the University of Houston System, and its related components, is part of and included in the State of Texas Comprehensive Annual Financial Report, upon which an opinion is expressed. The state's financial statements are audited by the State Auditor.

Entity

The University of Houston System (the System) is an agency of the State of Texas and its financial records comply with state statutes and regulations. This includes compliance with the Texas Comptroller of Public Accounts' Reporting Requirements for Annual Financial Reports of State Agencies and Universities.

The University of Houston System serves the state as the primary provider of educational and cultural opportunities, skilled employers and leaders, technical knowledge, and innovative research to the Houston metropolitan area and the upper Texas Gulf Coast region. Houston and the upper Gulf Coast region represent approximately one fourth of the state's population and economy.

The System was established by House Bill No. 188, Sixty-Fifth Legislature, Regular Session, effective September 1, 1977. Components of the System are System Administration (1977), University of Houston (1963), Clear Lake (1973), Downtown (1974), and Victoria (1973). The System

is governed by an appointed nine member Board of Regents.

During the 2002 fiscal year, the State of Texas adopted Governmental Accounting Standards Board (GASB) Statement No. 34, Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments, and GASB Statement No. 35, Basic Financial Statements - and Management's Discussion and Analysis - for Public Colleges and Universities. These accounting pronouncements established new reporting requirements including the presentation of new financial information and a restructuring of the presentation of previous fiscal years. Since the System's annual financial report is not subject to a separate financial audit, certain information, such as a complete set of Government-Wide Financial Statements, is not included in the accompanying report. The financial statements are presented in columnar form, including totals for prior year data. Prior year totals have been restated when necessary to reflect current year changes in reporting procedures and to permit comparability of reported totals.

No component units have been identified which should have been discretely presented in the financial statements.

BASIS OF ACCOUNTING

A. Fund Structure

The accompanying financial statements are presented on the basis of funds, each of which is considered a separate accounting entity. The operations of the System and its component universities are considered to be a Business-Type Activity. The System charges fees to external users for goods and services. Consequently the accompanying financial statements are presented using the Proprietary Fund type structure.

B. Basis of Accounting

The basis of accounting determines when revenues and expenses are recognized in the accounts reported in the financial statements. The accounting and financial reporting treatment applied to a fund is determined by its measurement focus.

Proprietary funds are accounted for on the accrual basis of accounting. Under the accrual basis of accounting,

revenues are recognized when earned and expenses are recognized at the time liabilities are incurred. Proprietary funds distinguish operating from non-operating items. Operating revenues and expenses result from providing services or producing and delivering goods in connection with the proprietary funds' principal ongoing operations. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets.

C. Budget and Budgetary Accounting

The budget is prepared biennially and represents appropriations authorized by the legislature and approved by the Governor (the General Appropriations Act). Additionally the System prepares an annual budget which represents anticipated sources of revenues and authorized uses. This budget is approved by the System's Board of Regents. Unencumbered appropriations are generally subject to lapse 60 days after the end of the fiscal year for which they were appropriated.

D. Assets, Liabilities, and Net Assets

ASSETS

Significant asset categories are summarized below.

Cash and Cash Equivalents

Short-term highly liquid investments with an original maturity of three months or less are considered cash equivalents.

Restricted Assets

Restricted assets include monies or other resources restricted by legal or contractual requirements. These assets include proceeds of revenue bonds and revenues set aside for statutory or contractual requirements.

Inventories and Prepaid Items

Inventories include both merchandise inventories on hand for sale and consumable inventories. Inventories are valued at cost, generally utilizing the last-in, first-out method. Prepaid items reflect payments for costs applicable to future accounting periods. The consumption method of accounting is used to account for inventories and prepaid items. The cost of these items is expensed when the items are consumed.

Capital Assets

Assets with an initial, individual cost of more than \$5,000 and an estimated useful life in excess of one year are capitalized. These assets are capitalized at cost or, if not purchased, at appraised fair value as of the date of acquisition. Depreciation is reported on all exhaustible assets. Inexhaustible assets such as works of art and historical treasures are not depreciated. Depreciation is charged to operations over the estimated useful life of each asset, using the straight-line method.

Other Receivables

Other current receivables include year-end revenue accruals not included in any other receivable category. Non-current receivable balances are not expected to be collected within one year of fiscal year end.

LIABILITIES

Significant liability categories are summarized below.

Accounts Payable

Accounts payable represent the liability for the value of assets or services received at the balance sheet date for which payment is pending.

Other Payables

Other current payables are the accrual at year-end of expenditure transactions not included in any of the other payable descriptions. Non-current payable balances are not expected to be paid within one year of fiscal year end.

Employees' Compensable Leave Balances

Employees' compensable leave balances represent the liability that becomes due upon the occurrence of relevant events such as resignations, retirements, and uses of leave balances by covered employees. Liabilities are reported separately as either current or noncurrent in the Statement of Net Assets.

Bonds Payable - Revenue Bonds

The bonds payable are reported at par, less unamortized discount or plus unamortized premium. Interest expense is reported on the accrual basis, with amortization of discount or premium. Payables are reported separately as either current or noncurrent in the Statement of Net Assets.

NET ASSETS

The difference between fund assets and liabilities is Net Assets.

Invested In Capital Assets, Net Of Related Debt

Invested in capital assets, net of related debt consists of capital assets, net of accumulated depreciation and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction, or improvement of those assets.

Restricted Net Assets

Restricted net assets result when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or enabling legislation.

Unrestricted Net Assets

Unrestricted net assets consist of net assets, which do not meet the definition of the two preceding categories. Unrestricted net assets often have constraints on resources, which are imposed by management, but can be removed or modified.

CAPITAL ASSETS

The System reports accumulated depreciation on its capital assets and recognizes depreciation expense as a current year charge.

At August 31, 2006, non-depreciable capital assets, consisting of land and construction in progress, totaled \$81,063,103. Depreciable capital assets, net of accumulated depreciation, and consisting of buildings, infrastructure, facilities, equipment, library books, and works of art, totaled \$458,325,991.

DEPOSITS AND INVESTMENTS

A. Deposits of Cash in Bank

At August 31, 2006, the carrying amount of the System's cash deposits was \$(187,134) and the bank balance was \$2,371,083. Additionally, \$12,386 was deposited in foreign banks and was neither covered by insurance nor collateralized. Foreign currency risk for deposits is the risk that changes in exchange rates will adversely affect the deposit.

B. Investments

The University of Houston System is authorized by statute to make investments following the "prudent person rule". There were no significant violations of legal provisions during the period.

The fair value of investments, including short-term, long-term, and money market cash equivalents, as of the balance sheet date was \$765,520,747.

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The general investment policy of the System limits investments in debt securities that are not in the top three investment grade ratings issued by nationally recognized statistical rating organizations to 5% of total investments. As of August 31, 2006, the System's credit quality distribution for securities with credit risk included significantly less than 5% of total investments that were not in the top three grade ratings.

Concentration of credit risk is the risk of loss attributable to the magnitude of investment in a single issuer. As of August 31, 2006, the System's concentration of credit risk in any single issuer did not exceed five percent of total investment assets as reported on the Statement of Net Assets.

C. Investment Transactions

Reverse Repurchase Agreements

The System, by statute, is authorized to enter into reverse repurchase agreements. The System did not invest in any reverse repurchase agreements during the fiscal year.

Securities Lending

Securities lending is authorized by state statutes. The System does not participate in a security-lending program.

Derivative Investing

The System did not hold any collateralized mortgage obligations at fiscal year-end. The System does not enter into forward-exchange contracts to manage exposure of foreign portfolio holdings to changes in foreign currency exchange rates.

Short Term Liabilities

The System holds a short term note payable, the proceeds of which were used to complete renovations of Hofhienz Pavillion. The remaining balance as of August 31, 2006 is \$65,145.

LONG TERM LIABILITIES

A. Notes and Loans Payable

The System reported no notes or loans payable at the end of the year ended August 31, 2006.

B. Claims and Judgments

At August 31, 2006, various lawsuits and claims involving the System and/or its components were pending. While the ultimate liability, if any, with respect to litigation and other claims asserted against the System cannot be reasonably estimated at this time, such liability, to the extent not provided for by insurance or otherwise, is not expected to have a material effect on System accounts.

C. Employees' Compensable Leave

A state employee is entitled to be paid for all unused vacation time accrued, in the event of the employee's resignation, dismissal, or separation from state employment, provided the employee has had continuous employment with the state for six months. An expense and liability are recorded as the benefits accrue to employees. The liability for unpaid benefits is recorded in the Statement of Net Assets. No liability is recorded for non-vesting accumulating rights to receive sick pay benefits.

Full-time state employees earn annual leave from eight to twenty-one hours per month depending on the respective employees' years of state employment. The state's policy is that an employee may carry his accrued leave forward from one fiscal year to another fiscal year with a maximum number of hours up to 532 for those employees with 35



CONTINGENT LIABILITIES

Various lawsuits and claims involving the System were pending. While the ultimate liability, if any, remains uncertain, management does not expect any possible adverse ruling to have a material effect on System accounts.

The System has received several federal grants for specific purposes that are subject to review and audit by the grantor agencies. Such audits could lead to a request for reimbursements to grantor agencies for expenditures disallowed under the terms of the grant. Based on prior experience, management believes such disallowances, if any, will be immaterial.

CONTINUANCE SUBJECT TO REVIEW

The System is not subject to the provisions of the Texas Sunset Act (Chapter 325, Texas Government Code Annotated). The Act provides for the regular assessment of the continuing need for state agencies to exist. Certain agencies, such as institutions of higher education and courts, are not subject to the Sunset Act.

LEASE OBLIGATIONS

The System may enter into long-term leases for financing the purchase of certain fixed assets. Such leases are classified as capital leases for accounting purposes. There were no reportable outstanding capital lease payments payable at August 31, 2006.

Included in expenditures reported in the financial statements is rent paid or due under operating leases of \$4,035,927. Future minimum lease rental payments under non-cancelable operating leases having an initial term in excess of one year, as of August 31, 2006, totaled \$8,790,135.

INTERFUND BALANCES

There are numerous transactions between funds and state agencies. At year-end, amounts to be received or paid are reported as (1) Interfund Receivables or Payables, (2) Due From or Due To Other Agencies, (3) Due From or Due To Other Funds, (4) Transfers In or Transfers Out, and (5) Legislative Transfers In or Legislative Transfers Out.

The System experienced routine transfers with other state agencies, which were consistent with the activities of the fund making the transfer. Repayment of interfund balances will occur within one year from the date of the financial statement.

RISK FINANCING AND RELATED INSURANCE

The University of Houston System is exposed to a variety of civil claims resulting from the performance of its duties. It is System policy to periodically assess the proper combination of commercial insurance and retention of risk to cover losses to which it may be exposed.

The System assumes substantially all risks associated with tort and liability claims due to the performance of its duties. Currently some commercial insurance is purchased, and the System is not involved in any risk pools with other government entities.

The System's liabilities are reported when it is both probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. Liabilities are reevaluated periodically to consider current settlements, frequency of claims, past experience and economic factors.

SEGMENT INFORMATION

The System has no segment activity that requires separate disclosure in the notes to the financial statements. A segment is an identifiable activity, or group of activities, reported as or within an enterprise fund or any other stand-alone entity that has one or more bonds or other debt instruments outstanding, with a revenue stream pledged in support of that debt. In addition, the activity's revenues, expenses, gains and losses, assets, and liabilities are required to be accounted for separately.

BONDED INDEBTEDNESS

A. Outstanding Revenue Bonds

Consolidated Revenue Bonds, Series 1997

- ◆ To acquire, purchase, construct, improve, enlarge or equip property, land, buildings, structures, facilities, roads or infrastructure for the University of Houston-Victoria.
- ◆ Issued 8-1-97.
- ◆ \$5,150,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service-Designated tuition and various other revenues and balances that may be legally available for payment of debt obligations (funding for fiscal year 2006 from legislative appropriation).
- ◆ All outstanding bonds maturing subsequent to 8-15-07 will be paid in full with the proceeds from Consolidated Revenue Refunding Bonds, Series 2006.

Consolidated Revenue Bonds, Series 1998

- ◆ To finance the acquisition, purchase, construction, improvement, renovation, enlargement, and equipping of any property, building, structure, activity, service, operation, or facility of the University of Houston, specifically energy conservation projects.
- ◆ Issued 1-1-98.
- ◆ \$14,565,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service – Tuition, state appropriations, and various other revenues and balances that may be legally available for payment of debt obligations.

Consolidated Revenue Bonds, Series 1999

- ◆ To finance the acquisition, purchase, construction, improvement, renovation, enlargement, and equipping of any property, building, structure, activity, service, operation, or facility of the University of Houston System, specifically projects at the University of Houston, University of Houston - Downtown, University of Houston - Victoria, and the University of Houston multi-institutional teaching center in Fort Bend County.
- ◆ Issued 1-1-99.

- ◆ \$33,350,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service - Tuition and various other revenues and balances that may be legally available for payment of debt obligations (funding for fiscal year 2006 from Legislative appropriation).

Consolidated Revenue Bonds, Series 2000

- ◆ To construct a recreation and wellness facility at the University of Houston.
- ◆ Issued 9-1-00.
- ◆ \$52,070,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service – Tuition and various other fees, and revenues and balances that may be legally available for payment of debt obligations.
- ◆ All outstanding bonds maturing subsequent to 2-05-10 will be paid in full with the proceeds from Consolidated Revenue Refunding Bonds, Series 2006.

Consolidated Revenue Bonds, Series 2002-A

- ◆ To finance the acquisition, purchase, construction, improvement, renovation, enlargement, and equipping of any property, building, structure, activity, operation, or facility of the University of Houston System.
- ◆ Issued 9-1-02.
- ◆ \$130,955,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service – Tuition and various other revenues and balances that may be legally available for payment of debt obligations (partial funding for fiscal year 2006 from Legislative appropriation).

Consolidated Revenue Variable Rate Demand Bonds, Series 2004

- ◆ To finance the acquisition, purchase, construction, improvement, renovation, enlargement, and equipping of any property, buildings, structures, facilities, roads, or related infrastructure for the University of Houston System, including the individual campuses of the System.
- ◆ Issued 6-16-04.
- ◆ \$25,000,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service – Tuition and various other fees, and revenues and balances that may be legally available for payment of debt obligations (funding for fiscal year 2006 from Legislative appropriation).

Consolidated Revenue Bonds, Series 2005

- ◆ To construct a parking garage facility at the University of Houston.
- ◆ Issued 4-1-05.
- ◆ \$25,800,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service – Tuition and

various other fees, and revenues and balances that may be legally available for payment of debt obligations.

Consolidated Revenue Bonds, Series 2006

- ◆ To finance the acquisition, purchase, construction, improvement, enlargement and equipping of property, buildings, structures, activities, services, operations and other facilities, roads or related infrastructure for or on behalf of the University of Houston System, and the individual campuses of the System, including construction of a new classroom and office building for the University of Houston- Downtown.
- ◆ Issued 2-1-06.
- ◆ \$35,140,000: All bonds authorized have been issued.
- ◆ Source of revenue for debt service-Tuition and various fees, and revenues and balances legally available for payment of debt obligations.

Consolidated Revenue Refunding Bonds, Series 2002-B

- ◆ To refund \$27,415,000 of Consolidated Revenue Refunding Bonds, Series 1993 and \$19,385,000 of Consolidated Revenue Bonds, Series 1993-A.
- ◆ Issued 11-1-02.
- ◆ \$45,425,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service – Designated tuition and various other revenues and balances that may be legally available for payment of debt obligations.
- ◆ Average rate of bonds refunded - 5.4% (1993) and 5.5% (1993-A).
- ◆ Net proceeds from refunding series - \$47,871,000, after receipt of bond premium of \$2,888,998 and payment of \$442,998 in underwriting fees, insurance, and other issuance costs.
- ◆ Funds were used to purchase state and local government securities which were deposited in an irrevocable trust with an escrow agent to provide for all future debt payments on the 1993 and 1993-A series bonds, when the bonds were called for early redemption on 2-15-03.
- ◆ The 1993 and 1993-A series bonds are considered fully defeased and the liability for those bonds has been removed.
- ◆ Refunding of the 1993 and 1993-A series bonds reduced the System's debt service payments over the life of the bond issues by approximately \$3,228,503.
- ◆ Economic gain - \$2,733,595; the difference between the net present value of the old and new debt service payment.

Consolidated Revenue Refunding Bonds, Series 2006

- ◆ To refund \$3,295,000 of Consolidated Revenue Refunding Bonds, Series 1997 (University of Houston-Victoria) and \$44,430,000 of Consolidated Revenue Bonds, Series 2000 (University of Houston).
- ◆ Issued 2-01-06.

- ◆ \$48,450,000; all bonds authorized have been issued.
- ◆ Source of revenue for debt service-Tuition, designated tuition and various other fees, revenues and balances that may be legally available for payment of debt obligations. (Funding for fiscal year 2006 partially from Legislative appropriation).
- ◆ Average rate of bonds refunded - 5.45% (1997) and 5.45% (2000).
- ◆ Net proceeds from refunding series - \$49,799,345, after receipt of bond premium of \$1,823,210 and payment of \$473,865 in underwriting fees, insurance, and other issuance costs.
- ◆ Funds were used to purchase state and local government securities which were deposited in an irrevocable trust with an escrow agent to provide for all future debt payments on the refunded 1997 and 2000 series bonds. The refunded 1997 series will be called for early redemption on 8-15-07, and the 2000 series bonds will be called for early redemption on 2-15-10.
- ◆ The 1997 series bonds maturing subsequent to 8-15-2007 and the 2000 series bonds maturing subsequent to 2-15-10 are considered fully defeased and the liability for those bonds has been removed from the Investment in Plant fund group.
- ◆ Refunding of the 1997 and 2000 series bonds reduced the System's debt service payments over the life of the bond issues by approximately \$4,841,586.
- ◆ Economic gain - \$3,013,573; the difference between the net present value of the old and new debt service payment.

General Obligation Bonds

At August 31, 2006, the System had no bonds payable classified as General Obligation Bonds.

B. Changes In Bonded Indebtedness

Bonds payable are due in annual installments varying from \$2,960,000 to \$20,720,000 with interest rates from 2.00% to 7.00%, with the final installment due 2-15-2030.

C. Future Debt Service Requirements

Principal and interest requirements on the obligations for the next five years were \$152,188,941 and \$313,772,014 for the remaining 20 years.

DISCOUNTS AND ALLOWANCES

The System reports revenues net of discounts and allowances in proprietary funds. Discounts and allowances are calculated based on historical experience. For the fiscal year 2006 discounts and allowances that related to tuition and fee revenues totaled \$52,586,026.

EMPLOYEES RETIREMENT PLANS

The State has joint contributory retirement plans for substantially all its employees. The System participates in the plans administered by the Teachers Retirement System of Texas. Future pension costs are the liabilities of the Retirement System. The Retirement System does not account for each state agency separately. Annual financial reports prepared by the Retirement System include audited financial statements and actuarial assumptions and conclusions.

The state has also established an Optional Retirement Program for institutions of higher education. Participation in the Optional Retirement Program is in lieu of participation in the Teacher Retirement System. The Optional Retirement Program provides for the purchase of annuity or mutual fund contracts. Since these are individual investment product contracts, the state has no additional or unfunded liability for this program.

DEFERRED COMPENSATION

State employees may elect to defer a portion of their earnings for income tax and investment purposes pursuant to authority granted in the Texas Government Code Annotated, Section 609.001. Two plans are available for employees' deferred compensation plans. Both plans are administered by the Employees Retirement System.

The State's 457 plan complies with the Internal Revenue Code Section 457. The State also administers another plan, "TexaSaver," created in accordance with Internal Revenue Code Sec. 401(k). The assets of this plan do not belong to the state. The state has no liability related to this plan.

The tax deferred investment program permits benefits-eligible employees of the University of Houston System to purchase qualified tax deferred investments with a portion of their salaries. Participation in the program is voluntary and is a supplement to the Teacher Retirement System or the Optional Retirement Program. It is however, separate and apart from either.

RESTATEMENT OF NET ASSETS

During fiscal year 2006, no adjustments were made which required the restatement of the reported amount of fund balances and fund equity.

RELATED PARTIES

The System is affiliated with several foundations and organizations that have been created to benefit certain operations of the System. These organizations are considered to be separate legal entities, and as such are not considered component units as defined by generally accepted accounting principles. Therefore, the account balances and financial transactions of these organizations are not included in the System's financial statements.

Several student housing facility projects have been constructed by private external entities in order to enhance the residential life experience of students at various System campuses. The participating entities have financed and constructed housing complexes on System owned property adjacent to the university campus. These facilities are operated under ground leases and management agreements with the System for extended time periods. Under the terms of the agreements, cash revenues from rental income, net of operating expenses, are shared with the University. Repayment of project financing is serviced from revenues generated by the housing projects, and is the sole responsibility of the external entity. The related loans and bonds are not liabilities of the System or component universities.

SUBSEQUENT EVENTS

During October 2006 the System established a commercial paper program. It is anticipated that commercial paper will be issued to provide interim financing for various capital projects within the System. As of the date this report was issued, there have been no occurrences since August 31, 2006 that had a significant financial impact.

Financial Staff



John M. Rudley
*Vice Chancellor for
Administration and Finance*



Jim C. McShan
*Associate Vice Chancellor
for Finance*



David J. Ellis
*Executive Director of
Financial Reporting*



Michael T. Glisson
Executive Director of Finance



Beverly Ruffin
*Project Director
for Finance*



Thomas Ehardt
*Executive Director for Budget
Administration & Analysis*



Emily Messa
*Executive Director, Customer
Service/Business Services*



Raymond Bartlett
Treasurer



Financial Reporting Staff (from the left to right) Nakia Harrison, Linda Klemm, Carole Bohnert, Gwendolyn Jenkins Allen, Kevin Draper, Juanita Broughton and Phyllis Rusk, (not available for picture)



UHS Chief Accounting Officers (clockwise, from the top): Altaf Rajan, David Ellis, George Anderson (UHD), Mike Glisson, John Cordary (UHCL), Toni Wyer (UHV), and Beverly Ruffin (not available for picture).

This report was prepared with the assistance of Roddy Chambliss and the staff at the University Copy Center and Roger Cook, graphics designer.

The University of Houston System is an Equal Opportunity/Affirmative Action institution. Minorities, women, veterans and persons with disabilities are encouraged to apply.

