VIRGINIA STATE UNIVERSITY

REPORT ON AUDIT

FOR THE YEAR ENDED

JUNE 30, 2004

Auditor of
Public Accounts
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of Virginia State University for the year ended June 30, 2004, found:

- the financial statements are presented fairly, in all material aspects;
- internal control matters that we consider to be reportable conditions; however, we do no consider any of these to be a material weakness;
- no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards; and
- the University has not taken adequate corrective action with respect to the previously reported finding “Improve Contract Administration.” Adequate corrective action has been taken with respect to audit findings reported in the prior year that are not repeated in this report.

We recommend that the University improve:

- contract administration policies and procedures over goods and services contracts;
- documentation of operating policies and procedures;
- the process used to reconcile bank statements to the accounting system;
- documentation of system changes; and
- user account management and password controls to critical systems.

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INTERNAL CONTROL AND COMPLIANCE FINDINGS AND RECOMMENDATIONS

Over the last year, the University has experienced significant employee turnover in several key positions including but not limited to the Vice President for Administration and Finance, Controller, Budget Director, Manager of General Accounting, Cash and Investments Manager, Director of Purchasing, and Payroll Manager. The University has filled some of these positions, but many positions have remained vacant and at times the University had to rely on temporary employees and support from Commonwealth's Central Service agencies to perform functions necessary for day-to-day operations. As a result of this turnover, the University has many new staff in these positions or has had to increase staff workloads due to the positions that remained unfilled. We believe that the vacancies have resulted in the findings documented below and several other minor issues that we have not included in this report.

Improve Contract Administration

As noted in prior years, the University needs to improve its contract administration policies and procedures over its goods and services contracts. The University spends approximately 23 percent of its total budget or $19 million annually on contracts to outsource various services. The University considers these contractors an integral part of the University's overall operations.

As a result of prior year recommendations, the University initiated an internal review of its contract administration by an employee that is independent of the contract administration process. The independent reviewer will develop a process to review the University's four major contracts. The University also created the Director of Contract Administration position to ensure all contract administration meets State standards including whether contract officers, contract administrators, and contractors perform their duties as set out in the contract.

While the University has made progress, we continue to note problems in this area that the University needs to address to ensure the vendors are providing the service at the level for which they contracted. During our review, we identified the following issues.

- The University needs to improve its process for both documenting its contract administrators' understanding of their responsibilities as required by the Agency Procurement and Surplus Property Manual (APSPM) and evaluating if the administrators have performed these duties adequately.

- The contract administrators did not perform annual evaluations for some contracts and for others performed the evaluation late. In some circumstances, it appears the administrator performed the evaluation without all information and knowledge in order for them to adequately evaluate the performance of the contractor.

- The University did not obtain sufficient information about one contractor's charges in order to evaluate whether the contractor actually rendered the services. The invoice did not contain a breakdown of the charges for the various services provided under the contract.

- For one contract reviewed, the contract administrator was the same person who signed the contract and all contract modifications, which represents an improper separation of duties.

- The University modified the original contract for one of its contractors to require them to supply a contract officer and procurement practitioner. This contract officer ultimately oversaw the very contract under which she was hired, which represents a conflict of interest.

Contract administrators are an important control in the on-going management of the University's contracts. Without proper and timely designation and communication of contract administrators there is a risk that the University could pay for services it did not receive.

Further, management needs to ensure that both the contract administrators and the rest of the University community understands the contract administrator's duties and responsibilities to ensure they can adequately evaluate the performance of the contractor. The University should continue to improve its policies and procedures for their contract administrators. As such, contract administrators should know contract terms, prices, and values in order to fully understand and evaluate on-going contract performance.

The University should designate contract administrators in writing and have them perform annual reviews of all multi-year contracts. The contract administrator should perform the reviews in a timely manner to ensure the adequate monitoring of contracts. In addition, the University should evaluate the performance of the contract administrator and take appropriate action to remove those administrators not performing their duties adequately.

Document Policies and Procedures

The University has some of its operating policies and procedures documented; however, they have not documented all of the day-to-day operating procedures, which are an important component of the University's internal control structure. The lack of documented policies and procedures increases the risk of fraud and the likelihood that errors and improper payments could occur and go undetected. The auditor reviewed the official University policies and found that many are outdated and also do not provide procedures needed in order to follow the policies.

While the University should review all of its policies and procedures to ensure they are sufficient, it should focus on the following critical areas.

- *Financial Reporting* – The University lacks specific written financial statement procedures. Management should document its policies and procedures for developing financial statements and recording year-end journal entries. The University should systematically document all recurring financial statement procedures including sources of information used. Procedures should provide a priority of deliverables by due dates for all relevant information and assign tasks to the appropriate positions or individuals. One individual should have responsibility for reviewing the items as staff complete them, to ensure all items are completed by the applicable due date.

- *Human Resources and Payroll* – The University spends approximately $40 million annually on salaries and fringe benefits for its employees. Therefore, it is important that the University document its procedures for managing the human resources and payroll functions. Management should document its procedures for processing terminated employees, managing wage employees, performing monthly reconciliations, and certifying payroll.

- *Removal of Account Access* – During the audit, we found some terminated employees still had access to the system for up to 12 months after termination. The failure to delete access for terminated employees could result in inappropriate access to the University's critical systems. The University should improve and then follow its documented policies and procedures for removing separated employees or unnecessary system accounts. Specifically, the University needs to improve the process of monitoring and notification for terminated employees to ensure timely removal.

Documenting critical operating policies and procedures will ensure continuity of operations in the event of the loss of key personnel, which the University has recently experienced. Having these policies will assist management in ensuring uniformity and consistency in day-to-day operations, analyzing performance, and recording transactions in the accounting systems.

Improve Reconciliation Process

The University should improve the process used to reconcile bank statements to its accounting system. University staff did not complete the year-end reconciliations for the University's local bank account and Perkins Loan Fund account until mid-September due to the high quantity of reconciling items and adjustments. In addition, the University did not close its accounting system until late August, which contributed to the University's inability to complete the reconciliations in a timely manner.

We also noted that as of February 2005, October 2004 was the most recent reconciliation completed for the local bank account, which is the largest account the University manages. While the University had prepared the reconciliations, it had not resolved all of the reconciling items.

Accurate and complete reconciliations represent fundamental internal controls necessary to ensure that financial information within the University's accounting system is valid. Therefore, it is important that the University improve its reconciliation process to ensure they are complete in a timely manner.

Improve Documentation of System Changes

The University lacks sufficient policies and procedures for software and hardware change management. As a result, the University's documentation related to the change management process does not provide an adequate audit trail to provide assurance that critical controls are in place surrounding this process. Specifically, the University's procedures do not require sufficient documentation regarding the initial request phase of the change management process. In addition, the University's documentation and System Service Request forms do not provide an audit trail showing the following:

- That the programming supervisor reviewed and approved the change.
- The user department manager approved the change.
- Someone other than the programmer moved the change into the production environment.
- Someone other than the programmer recompiled the source code into the object code production library.

The failure to properly document all software and hardware maintenance changes, especially for the above items, could compromise the systems or network's integrity since failure to perform this work could result in changes that compromise or accidentally alter critical information in the production environment. In addition, without having properly documented and approved infrastructure changes, the entire network could face the same result.

We recommend the University modify its policies and procedures to ensure documentation of software and hardware changes provides an audit trail for each change. The audit trail will show the appropriate approval, provide assurance of the systems or network's integrity and provide a documented rollback plan if necessary. In addition, the University should implement a monitoring process to ensure staff are both documenting and performing the change management process appropriately.

Improve User Account Management and Password Controls to Critical Systems

The University does not maintain documentation as required by its policies and procedures of approval of user access requests for the security application on its mainframe. The failure to document authorization of user access privileges increases the risk of unauthorized access to critical systems. The documentation provides accountability and authorization for all users of these systems. Under the current University practices someone can receive or have their access changed without proper approval. The University should ensure completion and approval of user access request forms for all system accounts.

In addition, the University does not have strong password requirement settings on their critical systems and lacks a written password requirements policy for application and mainframe accounts. The University should change password settings to be in compliance with industry best practices for strong password controls for all systems. The University should document these settings in a policy for minimum password requirements and monitor compliance with this policy.

MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)

This section of the Virginia State University (the University) annual financial report represents a discussion and analysis of the financial performance of the University during the fiscal year ended June 30, 2004, with comparative information presented for the fiscal year ended June 30, 2003. This discussion has been prepared by management along with the financial statements and related footnote disclosures and should be read in conjunction with the financial statements and footnotes. The discussion and analysis is designed to focus on current activities, resulting change, and current known facts.

The financial statements, footnotes and this discussion are the responsibility of management.

Using the Annual Report

This annual report consists of a series of financial statements prepared in accordance with the Governmental Accounting Standards Board (GASB) Statement 35, *Basic Financial Statements - and Management's Discussion and Analysis - for Public Colleges and Universities.* The financial statements focus on the financial condition of University, the results of operations, and cash flows of the University as a whole.

The financial statements required by GASB Statement 35 are the Statement of Net Assets; Statement of Revenues, Expenses, and Changes in Net Assets; and Statement of Cash Flows. They are prepared under the accrual basis of accounting, whereby revenues and assets are recognized when the services are provided and expenses and liabilities are recognized when services are rendered, regardless of when cash is exchanged.

The Statement of Net Assets includes all assets and liabilities using the accrual basis of accounting. Net Assets, the difference between assets and liabilities, are one way to measure the financial health of the University. The increase or decrease in net assets over time demonstrates the financial health of the University. Net assets include three major categories. The first category, "Invested in capital assets, net of related debt," shows the University's equity in property, plant and equipment. The next category, "Restricted net assets," shows the amount of net resources available for certain University expenses. These net assets must be used for purposes determined by external entities at the time they were transferred to the University. The third category, "Unrestricted net assets," are the net resources available to the University to fund general operations.

The Statement of Revenues, Expenses, and Changes in Net Assets presents the revenues earned and the expenses incurred during the year creating the changes in the University's net assets. Activities are reported as either operating or nonoperating. Generally, operating revenues are received for providing goods and services to students and other constituencies of the institution. Operating expenses are those expenses incurred to acquire or produce the goods and services provided in return for the operating revenues and to carry out the University's mission. Nonoperating revenues are revenues received for which goods and services that are not directly provided. The financial reporting model classifies state appropriations and gifts as nonoperating revenues. Since state appropriations and private gifts are reported as non-operating revenue, although the University depends on them to fund operating expenses, the Statement of Revenues, Expenses, and Changes in Net Assets will display an operating deficit. The utilization of long-lived assets, referred to as capital assets, is reflected in financial statements as depreciation, which amortizes the cost of an asset over its expected useful life.

The Statement of Cash Flows presents information relating to cash inflows and outflows summarized by operating, noncapital financing, capital financing and related investing activities, and helps measure the ability to meet financial obligations as they mature.

For fiscal year 2004, the University has implemented GASB Statement 39, *Determining Whether Certain Organizations are Component Units.* This statement addresses the conditions under which institutions should include associated fund-raising or research foundations as component units in its basic financial statements and how such component units should be displayed in the financial statements. Under the previous accounting standards, the University was not required to report component units. Under GASB Statement 39, the Virginia State University Foundation (VSU Foundation) and the Virginia State University Real Estate Foundation (VSUREF) qualify as component units for inclusion in the University's financial statements as displayed in separate columns herein. However, the following discussion and analysis does not include the financial condition and activities of these two foundations.

Financial Highlights

1. The Commonwealth anticipated a significant revenue shortfall in fiscal year 2004. As a result of the anticipated shortfall, all agencies had their budgets reduced. The University's budget was reduced by $2.0 million

2. The University had an increase in net assets of approximately $4 million in fiscal year 2004, which was offset by a $944,853 beginning fund balance adjustment. Therefore, the net increase in total net assets was approximately $3.06 million. The increase was due to three factors:

    a. Unrestricted net assets increased $3.15 million during the fiscal year.

    - Educational and General net assets decreased by $330,000 primarily because of year-end accrual entries recording liabilities for salaries and wages and accounts payable. One significant increase was the amount payable for those individuals who chose to take the Alternative Severance Option. This alone reduced net assets by approximately $200,000.

    - The net assets of Auxiliary Enterprises increased by $2.48 million. For the year, the University established an increase in student comprehensive fees, which assisted in providing more revenue to Auxiliary Enterprise fund. In addition, the University Apartments at Ettrick also affected Auxiliary Enterprises. The project reduced utilization of the dormitories (reducing revenue) but since the University's dormitories were above capacity in previous years, housing space had to be rented from a local hotel. This cost was not incurred in fiscal year 2004. Residents of the University Apartment at Ettrick not using the cafeteria also reduced the associated cost of that service.

    - Development activity increased the University's net assets by $250,000. The Advancement Office campaign, in conjunction with nationally syndicated radio disc jockey, Tom Joyner, was a big boost to these efforts.

    - Capital projects funded by unrestricted funds increased by $780,000.

    b. Restricted expendable assets decreased overall by approximately $7.32 million for the year due to an $8.54 million shift of net assets to investment in capital assets. The difference, approximately $1.22 million, was an increase to other restricted expendable funds, represented by an increase of $780,000 for restricted quasi endowments and term endowments related to the Title III endowment. Restricted scholarships and fellowships increased by $100,000 during the year. The remaining $340,000 related to increases in various departments and an increase in repayments to the University's loan funds.

c. Non-expendable net assets increased approximately $170,000 for additions to endowments.

d. Increases in capital assets and reductions in outstanding debt combined to generate a $7.06 million increase in invested in capital assets, primarily comprised of construction in progress, new equipment purchases, library acquisitions, reduced by depreciation.

Condensed Financial Statement Information

Condensed Statement of Net Assets
Fiscal Years June 30, 2004 and 2003 (in thousands)

	2004	2003
ASSETS		
Current assets	$ 31,926	$ 25,347
Noncurrent assets:		
Capital	74,552	67,625
Restricted cash and cash equivalents	30,883	38,970
Investments	9,086	7,788
Other	2,421	2,556
Total noncurrent assets	116,942	116,939
Total assets	148,868	142,286
LIABILITIES		
Current liabilities	15,847	11,643
Noncurrent liabilities	17,147	17,830
Total liabilities	32,994	29,473
NET ASSETS		
Invested in capital assets, net of related debt	64,740	57,677
Restricted:		
Nonexpendable	1,547	1,378
Expendable	35,278	42,598
Unrestricted	14,309	11,160
Total net assets	$115,874	$112,813

The University's total assets at year-end were $148.9 million and $142.3 million at June 30, 2004, and 2003, respectively. Capital assets, the largest single class of assets, increased by $6.9 million during fiscal year 2004, from $67.6 million to $74.6 million at year-end. This shows that the University is reinvesting in the assets needed to sustain its mission.

The liabilities of the University increased by $3.5 million for the year. A significant part of this increase is a result of the Department of Treasury's securities lending program that increased liabilities by $2.84 million. The program uses the University's idle cash for investments. Therefore, the University's accounting records show an increase in assets and an increase in liabilities associated with the program. Payments due to suppliers at year-end for accounts payable and due to contractors for retainage payable increased $1.18 million and deferred revenue increased $582,000. These increases were offset by a decrease of $741,000 in long-term debt, a decrease of $262,108 in deposits held in custody for others and a decrease of $79,000 in other long-term liabilities.

The University's current assets of $31.9 million were sufficient to cover the current liabilities of $15.8 million. The current ratio for fiscal year 2004 is $2.02 in current assets for every $1 in current liabilities. This is a decrease of $0.15 for the year.

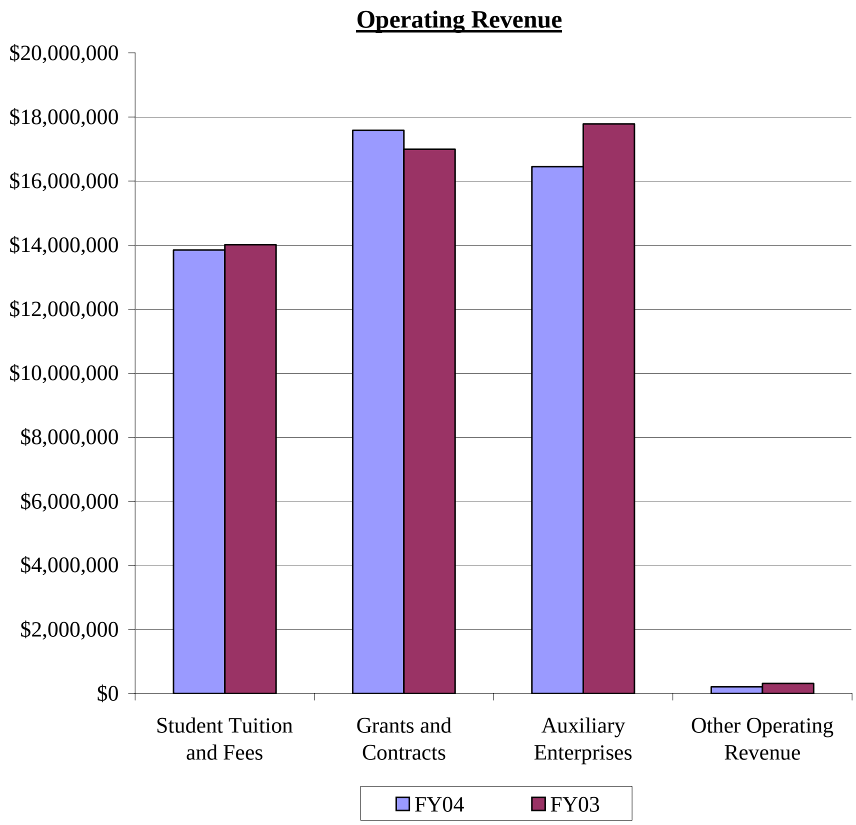
Total net assets of the University increased to $115.9 million at June 30, 2004, an increase of $3 million in net assets over the previous year's balance. As stated previously, investment in capital assets increased by $7.06 million, restricted non-expendable net assets increased $170,000, restricted expendable net assets decreased by $7.32 million, and unrestricted net assets increased $3.18 million.

Condensed Statement of Revenues, Expenses and Changes in Net Assets
For the years ended June 30, 2004 and 2003 (in thousands)

	2004	2003
Operating revenues	$ 48,086	$ 49,107
Operating expenses	79,597	78,277
Operating (loss)	(31,511)	(29,170)
Nonoperating revenues (expenses)		
State appropriations	31,873	31,752
Other nonoperating revenue and expenses	1,509	(1,217)
Net nonoperating revenues and expenses	33,382	30,535
Income before other revenues	1,871	1,365
Capital appropriations	1,576	26,298
Capital grants and gifts	469	650
Additions to endowments	90	109
Total other revenue	2,135	27,057
Total increase in net assets	4,006	28,422
Net assets, beginning of year	112,813	85,070
Restatement	(945)	(679)
Restated net assets, beginning of year	111,868	84,391
Net assets, end of year	$115,874	$112,813

The operating revenue for fiscal year 2004 and 2003 totaled $48,086,839 and $49,107,449, respectively. The distribution and bar chart of the distribution are presented below:

	FY04	FY03
Student tuition and fees	$13,843,211	$ 14,015,136
Grants and contracts	17,583,001	16,997,139
Auxiliary enterprises	16,448,150	17,779,303
Other operating revenue	212,477	315,871
Total operating revenue	$48,086,839	$ 49,107,449



The student tuition and fee revenue is shown net of tuition discounts and scholarship allowances. A tuition discount or scholarship allowance is the difference between the stated charge for goods and services provided by the University and the amount that is paid by students and/or third parties on their behalf. The gross student tuition and fees was $18,432,869 and auxiliary enterprise revenue was $21,899,024. The tuition discounts and scholarship allowances totaling $10,040,532 is divided between tuition and fees ($4,589,658) and auxiliary enterprises ($5,450,874).

As demonstrated on the following page, in both semesters of the fiscal year, the University had a decrease in overall enrollment. The decrease in enrollment caused tuition and fees to decrease for the year.

Also during fiscal year 2004, the Virginia State University Real Estate Foundation opened its apartment complex in Ettrick, which reduced auxiliary revenue.

Student Classification	Fall 2003	Fall 2002	Change
IS full-time undergraduate	2414	2402	12
IS full-time graduate	85	76	9
IS part-time undergraduate	297	299	(2)
IS part-time graduate	756	710	46
OS full-time undergraduate	1305	1418	(113)
OS full-time graduate	18	21	(3)
OS part-time undergraduate	29	26	3
OS part-time graduate	29	27	2
	4,933	4,979	(46)

Student Classification	Spring 2004	Spring 2003	Change
IS full-time undergraduate	2264	2222	42
IS full-time graduate	75	294	(219)
IS part-time undergraduate	296	83	213
IS part-time graduate	601	750	(149)
OS full-time undergraduate	1173	1317	(144)
OS full-time graduate	21	27	(6)
OS part-time undergraduate	28	22	6
OS part-time graduate	25	23	2
	4,483	4,738	(255)

In contrasting Fall 2002 with Fall 2003, the University increased tuition, room, and, board and comprehensive fees for in-state undergraduate by 5.51 percent, in-state graduate students by 5.6 percent, out-of-state undergraduate students by 4.24 percent, and out-of-state graduate students by 4.28 percent. The above percentage increases do not consider the two new fees (Rogers Stadium Capital Fee and State Capital Outlay Fee) and surcharge for fall 2003. Considering these factors, the increases in tuition are as follows: 12 percent for in-state undergraduate, 11.49 percent for in-state graduate increases, 8.32 percent for out-of-state undergraduate, and 8.15 percent for out-of-state graduate.

Operating Expenses

Operating expenses totaled $79.6 million and $78.3 million, respectively for fiscal years 2004 and 2003. The functional line showing the greatest change was Academic Support (a $1.96 million increase). The increase in Academic Support was due to furnishing purchased for the renovation of Johnston Memorial Library, the funding of two Title III projects (Race Relations and Hotel and Restaurant Management), and the reclassification of the Academy for Academic Development from institutional support. The largest decrease occurred in Auxiliary Enterprises ($1.23 million). With the opening of the University Apartments at Ettrick, fewer students stayed on campus affecting Residence Facilities revenue and meals purchased in the cafeteria. There was a combined decrease in operations and maintenance and institutional support of $1.0 million due to changes in the cost allocation. The increase of $1.5 million in instruction, research, and public service is due in part to the allocation of operation and maintenance and institutional support cost along with increases for the six new programs funded by the legislature in fiscal year 2002. The operating expenses distributed functionally are as follows:

	Fiscal Year 2004	Fiscal Year 2003	$ Change	% Change
Instruction	$24,718,323	$24,201,872	$ 516,451	2.13%
Research	3,361,251	2,893,131	468,120	16.18%
Public service	4,779,945	4,277,237	502,708	11.75%
Academic support	4,963,853	2,999,694	1,964,159	65.48%
Student services	3,620,278	3,610,826	9,452	0.26%
Institutional support	7,322,153	7,689,463	(367,310)	(4.78)%
Operation and maintenance of plant	7,397,612	8,042,451	(644,839)	(8.02)%
Depreciation	6,260,111	6,294,206	(34,095)	(0.54)%
Scholarships and fellowships	1,105,676	954,495	151,181	15.84%
Auxiliary enterprise expenses	16,045,101	17,284,441	(1,239,340)	(7.17)%
Other operating expenses	23,436	29,380	(5,944)	(20.23)%
Total	$79,597,739	$78,277,196	$ 1,320,543	1.69%

Non-Operating Revenues and Expenses

The University's capital appropriations decreased dramatically for the year, decreasing $24.7 million, from $26.3 million to $1.6 million. The only capital appropriation received in fiscal year 2004 was for maintenance reserve projects. In fiscal year 2003, funding was received for the new Engineering and Technology building, the renovation of Gandy Hall, and several other ongoing projects (Johnston Memorial Library, Owens Hall, the Steam Tunnel Project and Handicap Access Projects). The total state and capital appropriations received in fiscal year 2004 was $33.4 million. In fiscal year 2003, state and capital appropriations totaled $58.1 million.

Investment income rose substantially from the previous year. In fiscal year 2003, investment income experienced a gain of $389,275 and in fiscal year 2004, there was a gain of $881,703; an increase of $492,428. The increase reflects the overall improvement in the financial markets.

Condensed Statement of Cash Flows
For the Years Ended June 30, 2004 and 2003

	2004	2003
Cash provided (used) by:		
Operating activities	$(24,064,842)	$(22,766,969)
Noncapital financing activities	33,059,041	31,170,703
Capital and related capital financing activities	(13,137,351)	37,694,956
Investing activities	(415,931)	415,921
Net increase (decrease) in cash and cash equivalents	(4,559,083)	46,514,611
Cash and cash equivalents, beginning of year	58,726,691	12,212,080
Cash and cash equivalents, end of year	$54,167,608	$ 58,726,691

The purpose of the Statement of Cash Flows is to provide information on the University's receipts and payments of cash. From this statement, readers should be able to assess the University's:

- ability to generate future net cash flows;
- ability to meet obligations as they come due; and
- need for external financing.

The University's cash and cash equivalents decreased by $4.56 million chiefly due to spending on capital projects, which was partially offset by the enhanced financial position of auxiliary enterprise operations.

Capital Assets and Debt Administration

Below is a summary of the fiscal year changes in capital assets:

	June 30, 2004	June 30, 2003*	Change
Non-depreciable	$25,749,714	$18,092,834	$7,656,880
Depreciable (net)	48,802,020	48,587,131	214,889
Total	$74,551,734	$66,679,965	$7,871,769

*as restated

Non-depreciable assets consist of land, inexhaustible works of art, and construction-in-progress. Construction-in-progress is the most significant of these assets and is the only non-depreciable asset to change in value this year. Construction-in-progress increased $7,656,880 for the year, increasing from $17,471,105 to $25,127,985. The University made significant progress on the several renovation projects this year, e.g., Johnston Memorial Library and Owens Hall.

Net depreciable assets are distributed as follows at the end of each fiscal year:

	2004	2003	Change
Buildings	$33,655,134	$34,515,969	$ (860,835)
Equipment	7,243,879	6,518,864	725,015
Improvements other than buildings	2,514,197	2,706,653	(192,456)
Infrastructure assets	2,762,626	2,841,893	(79,267)
Library books	2,626,184	2,003,752	622,432
Total assets	$48,802,020	$48,587,131	$ 214,889

For the year, depreciable assets increased by $214,889 (0.4 percent). The overall increase is due to the transfer of the Virginia Hall Auditorium and Handicap Access Project for the Home Management House to buildings from construction-in-progress and equipment and library book purchases, all of which were offset by depreciation. The most significant percentage increases this fiscal year to depreciable assets were library books (31.1 percent) and equipment (11.3 percent). Buildings actually showed an overall decrease due to depreciation.

Debt Administration

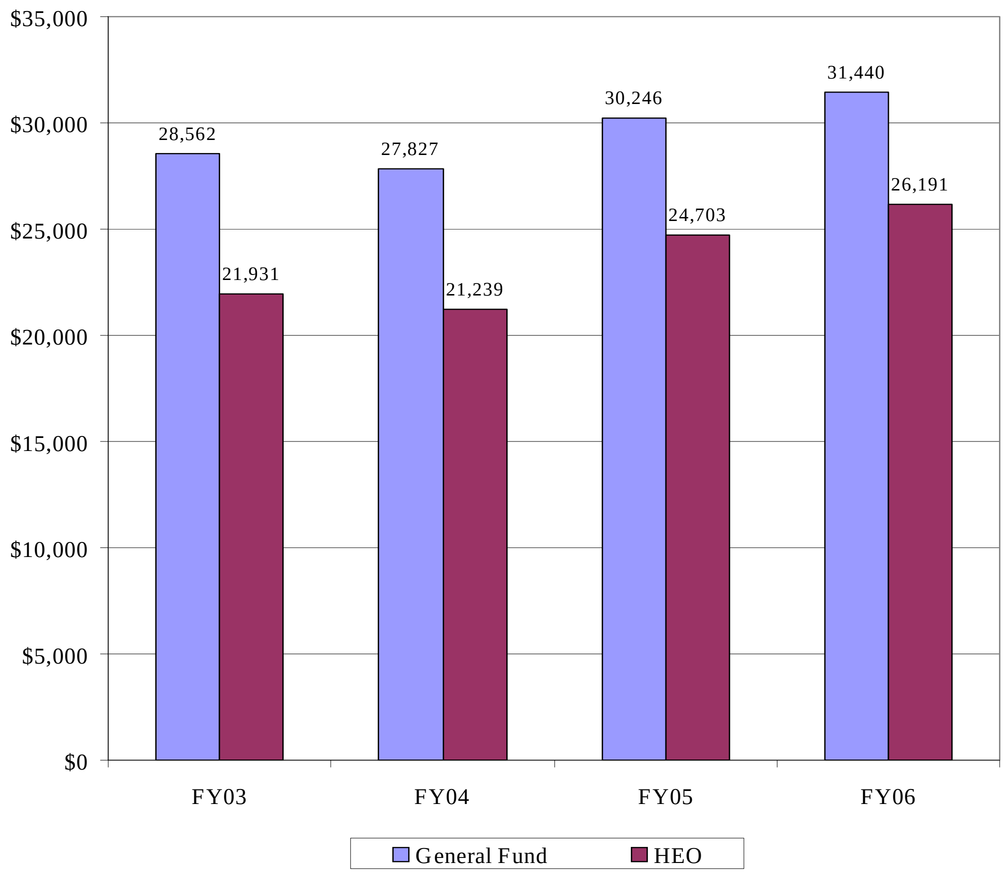
The University had outstanding long-term debt from financing activities of $15,794,805 at the beginning of the fiscal year. New debt was acquired for the purchase of buses during the year. Principal payments for the year of $1,042,967 reduced the outstanding debt to $15,099,519 by the close of the year. The June 30, 2004, long-term debt comprised of general obligation revenue bonds ($6,335,995), notes payable ($8,586,875), and installment purchases ($176,649). The current portion of this long-term debt totals $1,065,102.

As of June 30, 2004, the University was a party to construction contracts totaling approximately $15,827,301, of which $12,625,091 was incurred as of June 30, 2004. Unpaid commitments at June 30, 2004, are primarily for the renovation of the Johnston Library and Owens Hall. Further information relating to capital assets, construction, and capital debt is included in the Notes to the Financial Statements in Notes 4, 6, 7, and 11.

Factors Impacting Future Periods

The Commonwealth is currently experiencing an increase in revenue due to the current economic conditions, which has resulted in an increase to the University's educational and general funding. The University’s general fund and higher education operating funding increased by $5.8 million in fiscal year 2005. Refer to the chart on the following page.

VSU E&G Funding FY03 - FY06



For the Fall of 2004, the change in student mix and tuition and fee increases have had a positive effect on the fiscal year 2005 tuition and fee revenue, which is up approximately $1 million over Fall 2003. The Fall semester 2004 enrollment headcount decreased by 74 students. The drop is in part-time students, which are down by 270; full time students are up by 196. The tuition charged to students increased by $131 for in-state and out-of-state full-time undergraduate students, while tuition for graduate students increased by $144. Mandatory fees increased by $200 and room and board charges increased by $126. The revenue increase will assist in improving the University's overall financial strength.

The University, under an agreement between the Commonwealth of Virginia and the United States Department of Education, Office for Civil Rights, receives additional funding for the elimination of the vestiges of segregation in higher education in Virginia. The related fiscal year 2005 and 2006 funding was increased to support for the University’s six new academic programs. The increased funding totals $5.67 million; $2.79 million received in fiscal year 2005 and $2.88 million received in fiscal year 2006. The University will continue to work with the Commonwealth to further enhance facilities and garner support for preventive and deferred maintenance.

FINANCIAL STATEMENTS

VIRGINIA STATE UNIVERSITY
STATEMENT OF NET ASSETS
AS OF JUNE 30, 2004

	University	VSU Foundation	VSU Real Estate Foundation
ASSETS			
Current assets:			
Cash and cash equivalents (Note 2)	$ 23,285,014	$ 728,430	$ 561,970
Short-term investments (Note 2)	3,705,522	1,742,994	1,493,581
Accounts and loans receivable, net of allowance for doubtful accounts of $193,005 (Note 3)	2,314,202	49,226	111,875
Due from the Commonwealth (Note 3)	532,648	-	-
Inventory	433,910	-	-
Due from affliates	-	120,152	20,185
Prepaid expenses	1,575,405	-	724
Notes and mortgages receivable, net of allowance for doubtful accounts of $5,229 (Note 3)	79,609	-	-
Total current assets	31,926,310	2,640,802	2,188,335
Non-current assets:			
Restricted cash and cash equivalents (Note 2)	30,882,594	-	1,351,721
Restricted investments (Note 2)	284,252	-	-
Endowment investments (Note 2)	7,568,338	2,799,370	-
Notes and mortgages receivable, net of allowance for doubtful accounts of $147,205 (Note 3)	2,375,004	-	-
Other long-term investments (Note 2)	1,233,017	-	-
Unamortized issuance cost	28,789	-	639,134
Other assets	18,351	-	-
Non-depreciable capital assets (Note 4)	25,749,714	-	7,558,291
Depreciable capital assets, net (Note 4)	48,802,020	-	7,370,938
Total non-current assets	116,942,079	2,799,370	16,920,084
Total assets	148,868,389	5,440,172	19,108,419
LIABILITIES			
Current liabilities:			
Accounts payable and accrued liabilities (Note 5)	6,006,188	39,189	603,586
Deferred revenue	2,560,377	-	-
Retainage payable	531,374	-	-
Obligations under securities lending program (Note 2)	3,705,522	-	-
Deposits held in custody	874,020	-	123,836
Other current liabilities	-	187,257	1,357,617
Long-term liabilities - current (Notes 6 and 7)	2,169,573	-	-
Total current liabilities	15,847,054	226,446	2,085,039
Non-current liabilities:			
Long-term liabilities - non-current (Notes 6 and 7)	15,649,584	-	18,627,956
Other non-current liabilities (Note 6)	1,497,528	-	1,212,287
Total non-current liabilities	17,147,112	-	19,840,243
Total liabilities	32,994,166	226,446	21,925,282

VIRGINIA STATE UNIVERSITY
STATEMENT OF NET ASSETS
AS OF JUNE 30, 2004

	University	VSU Foundation	VSU Real Estate Foundation
NET ASSETS			
Invested in capital assets (net of related debt)	64,740,473	-	-
Restricted for:			
Nonexpendable:			
Scholarships and fellowships	1,078,050	-	-
Instruction	402,236	-	-
Other	66,547	2,799,370	-
Expendable:			
Capital projects	28,036,228	-	-
Scholarships and fellowships	6,205,051	-	-
Loans	611,290	-	-
Departmental uses	214,906	-	-
Other	210,068	886,249	-
Unrestricted	14,309,374	1,528,107	(2,816,863)
Total net assets	$ 115,874,223	$ 5,213,726	$ (2,816,863)

The accompanying Notes to the Financial Statements are an integral part of this statement.

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VIRGINIA STATE UNIVERSITY
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2004

	University	VSU Foundation	VSU Real Estate Foundation
Operating revenues:			
Student tuition and fees	$ 13,843,211	$ -	$ -
(net of scholarship allowances of $4,589,658)			
Federal grants and contracts	17,263,702	-	-
State and local grants and contracts	319,299	-	-
Sales and service - educational departments	97,413	-	-
Sales and service - auxiliary enterprises (Note 9)	16,448,150	-	-
(net of scholarship allowances of $5,450,874)			
Other operating revenues	115,064	-	2,305,612
Total operating revenues	48,086,839	-	2,305,612
Operating expenses: (Note 10)			
Educational and general:			
Instruction	24,718,323	-	-
Research	3,361,251	6,114	-
Public service	4,779,945	-	-
Academic support	4,963,853	3,920	-
Student services	3,620,278	-	-
Institutional support	7,322,153	177,615	4,007,620
Operation and maintenance of plant	7,397,612	-	-
Depreciation	6,260,111	-	196,663
Scholarships and fellowships	1,105,676	133,923	-
Auxiliary enterprise expenses (Note 9)	16,045,101	5,188	-
Other operating expenses	23,436	29,640	812,928
Total operating expenses	79,597,739	356,400	5,017,211
Operating income (loss)	(31,510,900)	(356,400)	(2,711,599)
Non-operating revenue (expense):			
State appropriations (Note 8)	31,873,294	-	-
Gifts	1,302,902	161,807	-
Investment income	881,703	284,675	128,783
Interest on capital asset-related debt	(750,653)	-	(234,047)
Interest on indebtedness	20,289	-	-
Loss disposal of assets	(4,044)	-	-
Other non-operating revenue	553,782	-	-
Other non-operating expenses	(495,085)	-	-
Net non-operating revenue (expense)	33,382,188	446,482	(105,264)
Income before other revenues, expenses, gains or losses	1,871,288	90,082	(2,816,863)
Capital appropriations (Note 8)	1,575,691	-	-
Capital grants and gifts	468,761	-	-
Additions to permanent endowments	90,300	163,726	-
Total other revenues	2,134,752	163,726	-
Increase (Decrease) in net assets	4,006,040	253,808	(2,816,863)
Net assets, beginning of year, as restated (Note 1N)	111,868,183	4,959,918	-
Net assets, end of year	$ 115,874,223	$ 5,213,726	$ (2,816,863)

The accompanying Notes to the Financial Statements are an integral part of this statement.

VIRGINIA STATE UNIVERSITY
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2004

Cash flows from operating activities:	
Tuition and fees	$ 13,938,600
Grants and contracts	17,511,377
Auxiliary enterprises	16,757,003
Other revenues	86,597
Payments to employees	(39,346,775)
Payments to suppliers	(26,684,652)
Payments for utilities	(3,572,152)
Payments for scholarships and fellowships	(2,801,713)
Loans issued to students	(291,721)
Collection of loans from students	431,903
Other payments	(93,309)
Net cash used by operating activities	(24,064,842)
Cash flows from noncapital financing activities:	
State appropriations	31,873,294
Gifts	1,393,202
Other nonoperating revenue	54,653
Funds held in custody for others - receipts	10,536,648
Funds held in custody for others - disbursements	(10,817,251)
Federal direct lending program receipts	25,086,683
Federal direct lending program disbursement	(25,068,188)
Net cash provided by noncapital financing activities	33,059,041
Cash flows from capital financing activities:	
Capital appropriations	1,575,691
Capital gifts and grants	468,761
Interest paid on capital-related debt	(733,508)
Principal paid on capital-related debt	(1,042,967)
Proceeds from issuance of capital debt	347,681
Purchase of capital assets	(13,753,009)
Net cash used by capital financing activities	(13,137,351)
Cash flows from investing activities:	
Proceeds from sales and maturities of investments	371,865
Purchase of investments	(787,796)
Net cash used by investing activities	(415,931)
Net decrease in cash	(4,559,083)
Cash and cash equivalents - beginning of the year	58,726,691
Cash and cash equivalents - end of the year	$ 54,167,608

RECONCILIATION OF NET OPERATING LOSS TO NET CASH USED BY OPERSTING ACTIVITIES:	
Operating income (loss)	$(31,510,900)
Adjustments to reconcile net cash used by operating activities:	
Depreciation expense	6,260,111
Changes in assets and liabilities:	
Receivables	(375,229)
Inventories	(65,762)
Prepaid items	196,357
Other assets	1,545
Accounts payable	798,597
Interest payable	3,144
Deferred revenue	581,967
Other liabilities	(124,996)
Net loans	170,324
Net cash used by operating activities	$(24,064,842)
NON-CASH INVESTING, CAPITAL AND FINANCING ACTIVITIES	
Principal and interest on capital debt paid by state agency on behalf of the University	$ 844,197

The accompanying Notes to the Financial Statements are an integral part of this statement.

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NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

Virginia State University (University), founded in 1882, is one of two land grant universities in the state, having been so designated in 1920. As a land grant institution, the University engages in natural resources related research projects and agricultural extension services. The institution attained university status in 1979. The University offers programs at the graduate and undergraduate levels in science, education, humanities, social science, and business. The University's stated mission is to prepare students to advance intellectually, socially, economically, and politically, so they and the University will make significant contributions to the enhancement of society.

The University is a component unit of the Commonwealth of Virginia and is included in the Comprehensive Annual Financial Report (CAFR) of the Commonwealth. These basic financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB) applicable to colleges and universities. They are prepared for and at the direction of the Commonwealth of Virginia for inclusion in the Commonwealth's CAFR, which includes all agencies, boards, commissions, and authorities associated with the University over which the Commonwealth exercises or has the ability to exercise oversight authority.

In fiscal year 2004, the University implemented GASB Statement 39, *Determining Whether Certain Organization are Component Units*, an amendment of GASB Statement 14, *The Financial Reporting Entity*. This statement addresses the conditions under which institutions should include associated fund raising or research foundations as component units in their basic financial statements and how such component units should be displayed in the financial statements. This statement is effective for the fiscal year ending June 30, 2004.

Prior to fiscal year 2004, the University had no component units, as defined by GASB Statement 14. However, under GASB Statement 39 standards, the Virginia State University Foundation (VSU Foundation) and the Virginia State University Real Estate Foundation (VSUREF) meet criteria qualifying them as component units of the University.

The VSU Foundation is a legally separate component unit of the University and was organized as a tax-exempt charitable and educational organization in 1968. The purpose of this Foundation is to accept contributions from individual donors and to safeguard, invest, and distribute the funds as designated by the donors or the Board of Trustees, for the benefit of the University, its students, alumni, and educational community, in support of the University's mission.

The VSUREF is a legally separate component unit of the University and was organized as a tax-exempt charitable and educational organization in 2002. Operations began in August

2003. The purpose of the Foundation is to construct and manage the University Apartments at Ettrick, a 504 bedroom facility for the University, in support of the University's mission.

Although the University does not control the timing or amount of receipts from either the VSU Foundation or the VSUREF, the majority of the resources, or income thereon, that both foundations hold and invest are restricted to the activities of the University by the donors. Because these restricted resources held by the foundation can only be used by, or for the benefit of, the University, the VSU Foundation and the VSUREF are considered component units of the University and are discretely presented in the University's financial statements.

During the year ended June 30, 2004, the VSU Foundation and the VSUREF distributed $85,222 and $675,453, respectively, to the University for both restricted and unrestricted purposes. Separate financial statements for the VSU Foundation can be obtained by writing Virginia State University Foundation c/o Larry Saunders & Associates, CPA's, 2902 Chamberlayne Avenue, Richmond, VA 23222. Separate financial statements for the VSUREF can be obtained by writing Virginia State University Real Estate Foundation c/o Vice President of Development, Storum Hall, P.O. Box 9027, Petersburg, VA. 23806.

B. Basis of Presentation

The University's accounting policies conform with generally accepted accounting principles as prescribed by GASB, including all applicable GASB pronouncements, as well as applicable Financial Accounting Standards Board (FASB) statements and interpretations, Accounting Principles Board opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The financial statements have been prepared in accordance with GASB Statement 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments,* and GASB Statement 35, *Basic Financial Statements and Management's Discussion and Analysis of Public College and Universities.*

The VSU Foundation and the VSUREF are private, nonprofit organizations that report under FASB standards, including FASB Statement 117, Financial Reporting for Not-for-Profit Organizations. As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition and presentation features. No modifications have been made to the Foundation's information in the University's financial reporting entity for these differences.

C. Basis of Accounting

The University's financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned and expenses are recorded when a liability has incurred, regardless of the timing of related cash flows. All significant intra-agency transactions have been eliminated.

D. Cash Equivalents

The University considers all highly liquid investments with an original maturity of 90 days or less to be cash equivalents. Funds invested through the State Non-Arbitrage Program (SNAP) and portions of the funds invested in the State Securities Lending Program are considered cash equivalents.

E. Investments

In accordance with GASB Statement 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, investments are recorded at fair market value at June 30, 2004. All investment income, including changes in the fair value of investments (unrealized gains and losses), is reported as nonoperating revenue in the Statement of Revenues, Expenses, and Changes in Net Assets.

F. Inventory

Inventory is valued at the lower of cost or market. The inventory held by the University consists of supplies held for consumption.

G. Capital Assets

Capital assets consisting of land, buildings, equipment, infrastructure assets, improvements other than buildings, and construction-in-progress are stated at appraised historical cost or actual cost, where determinable. Purchased or constructed capital assets are reported at cost. Donated capital assets are reported at fair value on the date of acquisition. Library books are valued at replacement cost as determined by the State Council of Higher Education. Equipment is capitalized when the acquisition cost is $5,000 or greater and the estimated useful life is one year or more. Expenses for construction in progress are capitalized as incurred. Infrastructure assets are recorded at cost. Depreciation is calculated using the straight-line method over the estimated useful life as follows:

Buildings	40-50 years
Infrastructure assets	15-20 years
Equipment	7-10 years
Library books	5 years
Other improvements	20 years

H. Restricted and Unrestricted Net Assets

Resources restricted by outside sources are distinguished from unrestricted resources allocated for specific purposes by action of the Board of Visitors. Externally restricted resources may be utilized only in accordance with the purposes established by the source of such resources and are in contrast with unrestricted resources, of which the governing board retains full control to use in achieving the institutional purpose.

Restricted net assets can be expendable or nonexpendable. Nonexpendable restricted net assets are endowments and similar type funds where the donor(s) or some other outside source has stipulated, as a condition of the gift instrument, that the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may either be expended or added to principal. Expendable restricted net assets are resources, which the University is legally or contractually obligated to spend in accordance with the restrictions imposed by external parties.

Unrestricted net assets are resources derived primarily from state appropriations, sales and services of educational departments, student tuition and fees, auxiliary enterprises fees and revenue, and gifts. Auxiliary enterprises are self-supporting activities that provide services for students, faculty and staff. These unrestricted resources are used for transactions relating to the educational and general operations of the University and at the discretion of the governing board to meet current expenses.

When an expense has incurred that can be paid using either restricted or unrestricted resources, the University's policy is first to apply the expense toward restricted resources, and then toward unrestricted. Restricted funds remain classified as such until restrictions have been satisfied.

I. Deferred Revenue

Deferred revenue represents moneys received but not earned as of June 30, 2004. Amounts for student tuition and fees received in advance of the academic term and revenues received from grant and contract sponsors but not spent or earned are considered as deferred revenue.

J. Accrued Compensated Absences

The amount of leave earned, but not taken by 12-month faculty and salaried employees is recorded as a liability on the Statement of Net Assets. The amount reflects all unused vacation leave, overtime leave, compensatory leave and the amount payable upon termination under the Commonwealth of Virginia's sick leave payout policy as of June 30, 2004. The applicable share of employer-related taxes payable on eventual termination payments is also included.

K. Revenue and Expense Classifications

Operating revenues include activities that have the characteristics of exchange transactions, such as: (1) student tuition and fees, net of scholarship discounts and allowances; (2) federal, state, and nongovernmental grants and contracts; and (3) sales and services of auxiliary enterprises, net of scholarships allowances.

Nonoperating revenues include activities that have the characteristics of nonexchange transactions such as gifts and other revenue sources that are defined as nonoperating revenues by GASB Statement 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, and GASB Statement 34, such as state appropriations and investment and interest income.

Nonoperating expenses include interest on debt related to the purchase of capital assets and investment expenses. All other expenses are classified as operating expenses.

L. Scholarship Discounts and Allowances

Scholarship allowances are the difference between the stated charge for goods and services provided by the University and the amount that is paid by the students and/or third parties on their behalf. Student tuition and fee revenues, and certain other revenues from students, are reported net of scholarship allowances. To the extent that revenues from certain governmental and nongovernmental grants and programs reported as either operating or nonoperating revenues in the financial statements are used to satisfy tuition and fees and other student charges such as room and board and comprehensive fees, these revenues have been defined as scholarship allowances and allocated to reduce student tuition and fees. This eliminates the historical practice of double counting restricted revenues received and used to pay for tuition and fees.

M. Federal Financial Assistance Programs

The University participates in federally funded programs such as Pell Grants, Supplemental Educational Opportunity Grants, Federal Work-Study, Direct Student Loans and the Perkins Loan programs. Federal programs are audited in accordance with the Single Audit Act Amendments of 1996, the Office of Management and Budget Revised Circular A-133, *Audit of States, Local Governments and Non-Profit Organizations*, and the Compliance Supplement.

N. Restatement of Beginning Net Assets

The beginning net assets of the University have been restated to $111,868,183. The University's balance for accumulated depreciation was understated at June 30, 2004, as a result of a system error in the calculation of depreciation for equipment. The restatement of beginning net assets is as follows:

Net assets, ending June 30, 2003	$112,813,036
Restatement of accumulated depreciation	(944,853)
Restated net assets, beginning July 1, 2003	$111,868,183

2. CASH AND CASH EQUIVALENTS AND INVESTMENTS

The following information is provided with respect to the credit risk associated with the University's cash and cash equivalents and investments at June 30, 2004.

A. Cash and Cash Equivalents

Pursuant to Section 2.2-1800, et seq., Code of Virginia (1950) as amended, all state funds of the University are held by the Treasurer of Virginia who is responsible for the collection, disbursement, custody and investment of state funds. Cash deposits held by the University are maintained in accounts that are covered by federal depository insurance or collateralized in accordance with the Virginia Security for Public Deposits Act, Section 2.2-4400 of the Code of Virginia. In accordance with the GASB Statement 9 definition of cash and cash equivalents, cash represents cash with the Treasurer of Virginia, cash on hand, and cash deposits including certificates of deposit and temporary investments with original maturities of three months or less. At June 30, 2004, the carrying amount of cash and cash equivalents was $54,167,608.

B. Investments

Statutes authorize the investment of local funds held by the University in obligations of the Commonwealth, federal government, other states of political subdivisions thereof, Virginia political subdivisions, the International Bank for Reconstruction and Development, the Asian Development Bank, and the African Development Bank. In addition, the University may invest in prime quality commercial paper rated Prime 1 by Moody's

Investment Service or A-1 by Standard and Poor's Incorporated. The University may also invest in overnight term or open repurchase agreements, and money market funds.

The University's investments, including short-term investments, are categorized below to give an indication of the level of credit risk assumed by the University at June 30, 2004. Credit risk is the risk that the University may not be able to obtain possession of its investment instrument or collateral at maturity. Risk category 1 includes investments which are insured or registered or for which the University or its safekeeping agent in the University's name hold the securities. Risk category 2 includes uninsured or unregistered investments for which the broker's or dealer or its trust department or safekeeping agent in the University's name holds the securities. Risk category 3 includes uninsured or unregistered investments for which the securities are held by the broker or dealer, or by its trust department or safekeeping agent, but not in the University's name. The University held no assets in either risk category 2 or 3 at June 30, 2004.

The composition and categorization of investments held by the University at June 30, 2004, is as follows:

Description	Category 1	Market Value	Cost
Investments:			
U.S. government securities	$ 1,421,386	$ 1,421,386	$ 1,454,331
Corporate stock	6,395,544	6,395,544	4,924,770
Corporate bonds	1,171,581	1,171,581	1,200,457
Subtotal	8,988,511	8,988,511	7,579,558
Money market funds	-	97,096	97,096
Security lending	-	3,705,522	3,705,522
Total investments	$ 8,988,511	$12,791,129	$11,382,176

The Virginia State University Foundation Cash and Investments

The investments of the VSU Foundation consist primarily of equity securities and mutual funds. All investments are stated at fair value as reported by the investment managers, and reflect readily determinable market prices. All investments are considered available for sale. Realized gains are calculated based on the difference between the cost and selling price of the security. Cost is determined based on the initial purchase price of each individual investment.

Investments held by the foundation at June 30, 2004, are summarized as follows:

Fair value	$4,542,364
Cost basis	$4,331,689

The Virginia State University Real Estate Foundation Cash and Investments

The investments of the VSUREF consist primarily of U.S. Government money market funds. All investments are stated at fair value as reported by the investment managers, and reflect readily determinable market prices. All investments are considered available for sale. Realized gains are calculated based on the difference between the cost and selling price of the security. Cost is determined based on the initial purchase price of each individual investment. The amount of investments held by the foundation at June 30, 2004, was $1,493,581.

C. Securities Lending Transactions

Investments held by the Treasurer of Virginia include the University's allocated share of securities totaling $3,705,522 received for securities lending transactions held in the General Account of the Commonwealth. Information related to the credit risk of these investments and securities lending transactions held in the General Account is available on a statewide level in the Commonwealth of Virginia's CAFR.

3. ACCOUNTS RECEIVABLE AND NOTES RECEIVABLE

A. Accounts Receivable

Accounts receivable is shown net of allowance for doubtful accounts in the accompanying Statement of Net Assets.

At June 30, 2004, accounts receivable consisted of the following:

Student tuition and fees	$ 354,158
Federal, state, and private grants and contracts	1,363,970
Auxiliary enterprises	111,218
Pledges	278,007
Other	91,954
Due from the VSUREF	120,643
Due from the VSU Foundation	187,257
Total	2,507,207
Less: Allowance for doubtful accounts	(193,005)
Net accounts receivables	$ 2,314,202

Pledges receivable represent pledges of financial support from corporations, foundations, and individuals. Pledges have been recorded as gifts and certain pledges are recorded at present value using a discount rate of five percent. Allowance for doubtful accounts includes an allowance on pledges receivable amounting to $55,601 which was computed by using a 20 percent uncollectible rate. This percentage was based on historical trend of pledges received.

B. Due from the Commonwealth

Receivables due from the Commonwealth represent reimbursement receivables for equipment purchases made by the University under the Equipment Trust Fund Program. On a reimbursement basis, this program provides state-supported institutions of higher education with bond proceeds for financing the acquisition and replacement of instructional and research equipment. Due from the Commonwealth shown on the Statement of Net Assets at June 30, 2004, is $532,648.

C. Notes Receivable

Notes receivable are shown net of allowance for doubtful accounts in the accompanying Statement of Net Assets.

At June 30, 2004, notes receivable consisted of the following:

Federal student loans	$ 1,736,514
Other loans	7,577
JPI Apartment Development, LP	25,000
The Virginia State University Real Estate Foundation	837,956
Total	2,607,047
Less: Allowance for doubtful accounts	(152,434)
Net notes receivable	$ 2,454,613

Net receivables not expected to be collected within one year is $1,537,048 for student loans and $837,956 for the Virginia State University Real Estate Foundation.

4. CAPITAL ASSETS

A summary of changes in the various capital asset categories for the year ending June 30, 2004, is presented as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Nondepreciable capital assets:				
Land	$ 267,084	$ -	$ -	$ 267,084
Inexhaustible works of art and/ or historical treasures	354,645	-	-	354,645
Construction in progress	17,471,105	10,008,661	2,351,781	25,127,985
Total nondepreciable capital assets	18,092,834	10,008,661	2,351,781	25,749,714
Depreciable capital assets:				
Buildings	91,288,238	2,752,039	-	94,040,277
Equipment	20,194,736	1,974,978	126,713	22,043,001
Infrastructure assets	8,293,948	328,590	-	8,622,538
Improvements other than buildings	3,807,859	48,782	-	3,856,641
Library books	14,755,992	1,374,653	-	16,130,645
Total depreciable capital assets	138,340,773	6,479,042	126,713	144,693,102

Less accumulated depreciation for:				
Building	56,772,269	3,612,875	-	60,385,144
Equipment	13,675,872	1,245,919	122,669	14,799,122
Infrastructure assets	5,452,055	407,856	-	5,859,911
Improvements other than buildings	1,101,206	241,238	-	1,342,444
Library books	12,752,240	752,221	-	13,504,461
Total accumulated depreciation	89,753,642	6,260,109	122,669	95,891,082
Depreciable capital assets, net	48,587,131	218,933	4,044	48,802,020
Total capital assets, net	$ 66,679,965	$ 10,227,594	$ 2,355,825	$ 74,551,734

The beginning balance for accumulated deprecation for equipment has been restated by $944,853 due to the prior period adjustment discussed in note 1N.

Net capital assets of the VSUREF consist of $7,558,291 for Land and Construction in Progress and $7,370,938 (net of accumulated depreciation of $148,815) for Buildings and Equipment for the year ending June 30, 2004.

5. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities consist of the following at June 30, 2004:

Employee salaries, wages and fringe benefits payable	$ 3,463,067
Matured interest payable	136,804
Vendor and supplies accounts payable	2,406,317
Total current liabilities – accounts payable and accrued liabilities	$ 6,006,188

6. NONCURRENT LIABILITIES

The University's noncurrent liabilities consist of long-term debt (further described in Note 7) and other noncurrent liabilities. A summary of changes in noncurrent liabilities for the year ending June 30, 2004, is presented as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Current Portion
Long-term debt:					
General obligation revenue bonds	$ 7,006,377	$ 18,681	$ 689,063	$ 6,335,995	$ 705,000
Notes payable	8,705,493	-	118,618	8,586,875	299,782
Installment purchases	82,935	329,000	235,286	176,649	60,320
Total long-term debt	15,794,805	347,681	1,042,967	15,099,519	1,065,102

Accrued compensated absences	2,765,157	1,440,399	1,485,918	2,719,638	1,104,471
Federal Perkins Loan contributions	1,577,005	-	79,477	1,497,528	-
Total long-term liabilities	$20,136,967	$1,788,080	$2,608,362	$19,316,685	$2,169,573

7. LONG TERM INDEBTEDNESS

A. Bonds Payable

The University's bonds are issued pursuant to Section 9 of Article X of the Constitution of Virginia. Most of the bonds at the university are section 9(c) bonds. These bonds are backed by the full faith, credit, and taxing power of the Commonwealth, and are issued to finance capital projects which, when completed, will generate revenue to repay debt.

The University had a total of $6,335,995 in bonds outstanding at June 30, 2004, consisting of the following:

	Interest Rates	Maturity	Total
General obligation revenue bonds:			
Langston Hall Project, Series 1995	2.50%-5.00%	2010	$ 590,000
Langston Hall Project, Series 2002R	3.30%	2010	660,832
Foster Hall Project, Series 1995	2.50%-5.00%	2010	530,000
Foster Hall Project, Series 2002R	3.30%	2010	592,102
Dorm Renovation Project, Series 1995	2.5%-5.00%	2010	615,000
Dorm Renovation Project, Series 2002R	3.30%	2010	690,169
Jones Dining Hall Project, Series 1996	2.5%-5.375%	2016	480,000
Jones Dining Hall Project, Series 2002R	3.30%	2016	1,357,553
Jones Dining Hall Project, Series 1998	4.67%	2018	820,339
Total bond payables			$6,335,995

Aggregate annual maturities of bonds payable for fiscal years after 2004 are:

Maturity	Principal	Interest	Total
2005	$ 705,000	$ 301,251	$1,006,251
2006	735,000	267,808	1,002,808
2007	780,682	231,839	1,012,521
2008	772,842	193,378	966,220
2009	857,022	153,999	1,011,021
2010-2014	1,805,401	356,481	2,161,882
2015-2018	674,709	59,705	734,414
Add: Unamortized Premium	5,339	-	5,339
Total	$6,335,995	$1,564,461	$7,900,456

B. Prior Year Defeasance of Debt

In prior years, the Commonwealth of Virginia, on behalf of the University issued General Obligation bonds and proceeds were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the refunded bonds. As a result, the bonds refunded are considered defeased and not reflected in the University's financial statements. At June 30, 2004, $3,300,657 of bonds outstanding were considered defeased.

C. Notes Payable

The University entered into a loan agreement with the Department of Housing and Urban Development (HUD) in 1989 and closed the agreement in 1992 to borrow funds to repair seven dormitories. The loan is to be repaid over 30 years at three percent interest per annum, and is secured by a lien on the net revenues from the ownership, operation, and use of the seven dormitories under repair. In prior years and in fiscal year 2004, the University participated in the Virginia College Building Authority (VCBA) Pooled Bond Program to fund the renovation of Rogers Stadium. As a participating institution in this program, the University issued a note payable to VCBA. This note, along with the notes of other institutions, is held by the VCBA as security for the Educational Facilities Revenue Bonds. At June 30, 2004, the outstanding balances were $2,429,040 for the HUD loan and $6,157,835 for the VCBA notes payable.

A summary of future principal and interest requirements of the HUD loan and VCBA notes payable as of June 30, 2004, are as follows:

Maturity	Principal	Interest	Total
2005	$ 299,782	$ 366,854	$ 666,636
2006	307,949	355,287	663,236
2007	321,212	342,274	663,486
2008	334,573	328,163	662,736
2009	348,036	313,450	661,486
2010-2014	1,985,903	1,321,157	3,307,060
2015-2019	2,469,595	823,833	3,293,428
2020-2023	2,206,990	210,823	2,417,813
Add: Unamortized Premium	312,835	-	312,835
Total	$8,586,875	$4,061,841	$12,648,716

D. Installment Purchases

In July 2000, the University entered into a five year Master Lease Agreement with IBM Corporation to provide financing of lighting equipment for the Rogers Stadium Athletic. The interest rate for this financing is 5.75 percent. At of June 30, 2004, the total installment lease obligation related to this Agreement was $42,656.

In November 2003, the University entered into a seven year Lease Purchase Agreement with Koch Financial Corporation to provide financing of buses. The interest rate for this financing is 3.39 percent. At of June 30, 2004, the total installment lease obligation related to this Agreement was $133,993.

Principal and interest payments on these commitments for fiscal years subsequent to June 30, 2004, are as follows:

Year	Principal	Interest	Total
2005	$ 60,320	$ 5,250	$ 65,570
2006	19,904	3,631	23,535
2007	20,589	2,947	23,536
2008	21,297	2,239	23,536
2009	22,029	1,507	23,536
2010-2011	32,510	832	33,342
Total	$ 176,649	$ 16,406	$193,055

E. Foundation Debt

The VSUREF has an unsecured line of credit in the amount of $1,000,000 with an interest rate of LIBOR plus 2 percent, (3.34 percent at June 30, 2004) and expiring February 28, 2005. The VSU Foundation guarantees the credit line.

To fund construction of the University Apartments at Ettrick, the VSUREF received proceeds from IDA Bonds issued by Chesterfield County. The bonds consist of a Series 2002A series for $17,710,000 and a Series 2002B series for $480,000. The bonds were issued November 19, 2002, and amended September 1, 2004. The bonds are collateralized by the rental property and equipment. Also, the VSUREF is required to maintain a debt service reserve with a minimum of $1,330,000. The contractual interest rates are variable (1.07 percent for Series 2002A and 1.25 percent for Series 2002B at June 30, 2004). The 2002A series matures on July 1, 2029, and the 2002B series matures on July 1, 2006. The VSUREF has agreed to prepayment terms of the principal to the Trustee with payments due on July 1, as follows: 2005-$215,000; 2006-$265,000; 2007-$300,000; 2008-$340,000; 2009-$395,000, thereafter $16,675,000.

The VSUREF has entered into an interest rate swap agreement as part of the provisions of the bond agreement. Per the terms of the swap agreement, the VSUREF pays a fixed rate of interest of 3.905 percent. The interest rate swap agreements qualify as derivative financial instruments and are used to mitigate the effect of interest rate fluctuations. The Foundation accounts for the interest rate swaps as fair value hedges whereby the fair value of these contracts are reflected in other liabilities in the accompanying statement of financial position with the offsets recorded as expenses. The fair value of these contracts was $812,287 at June 30, 2004. This is the amount the VSUREF would have to pay to settle the interest swaps as of June 30, 2004.

In conjunction with the bond issuance, the University signed a support agreement with the VSUREF stating that the University will make the University Apartments at Ettrick an equal part of the Student Housing Program, provide preferential treatment to provide 95 percent occupancy if the debt service coverage ratio is less than 1.2 to 1, and limit additional housing projects.

8. STATE APPROPRIATIONS

The University receives state appropriations from the General Fund of the Commonwealth. The Appropriations Act specifies that such unexpended appropriations shall revert, as specifically provided by the General Assembly, at the end of a biennium.

The following is a summary of state appropriations received by the University for the year ended June 30, 2004:

Virginia State University:	
Educational and general programs	$ 24,931,987
Higher education student financial assistance	2,733,361
Financial assistance for educational and general	117,500
Central appropriations	1,162,980
State grants	31,991
VSU cooperative extension and agricultural research services:	
Educational and general programs	2,895,475
Subtotal	31,873,294
Capital appropriations:	
Central maintenance reserve	1,575,691
Total	$ 33,448,985

9. AUXILIARY ACTIVITIES

Current year operating revenues and expenses for Auxiliary operations were received and distributed as follows:

Revenues:	
Food service	$ 4,782,997
Residential facilities	6,457,926
Student unions and recreational facilities	46,358
Intercollegiate athletics	574,008
Other auxiliary and sales services	10,037,735
Total auxiliary enterprises revenues	21,899,024
Less: Scholarship allowances	(5,450,874)
Net auxiliary enterprises revenues	$ 16,448,150

Expenses:	
Salaries, wages and fringe benefits	$ 4,374,893
Contractual services	4,882,823
Supplies and materials	898,722
Property and improvement	(27,471)
Equipment	958,095
Current charges and obligations	992,697
Scholarships	1,190,904
Indirect cost	2,695,104
Other auxiliary expenses	79,334
Total auxiliary enterprises expenses	$ 16,045,101

10. EXPENSES BY NATURAL CLASSIFICATIONS

The following table shows a classification of expenses both by function as listed in the Statement of Revenues, Expenses, and Changes in Net Assets and by natural classification, which is the basis for amounts shown in the Statement of Cash Flows.

Functional Classification	Salaries And Wages	Fringe Benefits	Services and Supplies	Utilities	Scholarship and Fellowships	Depreciation	Total
Instruction	$ 14,857,293	$ 4,260,130	$ 5,313,052	$ 131,605	$ 156,243	$ -	$24,718,323
Research	1,686,394	428,264	1,134,843	32,288	79,462	-	3,361,251
Public service	2,413,695	663,616	1,448,248	184,980	69,406	-	4,779,945
Academic support	2,228,673	626,477	2,003,956	25,735	79,012	-	4,963,853
Student services	2,098,869	480,331	825,475	42,631	172,972	-	3,620,278
Institutional support	3,999,538	1,685,778	1,498,805	133,471	4,561	-	7,322,153
Operation and maintenance of plant	(143,876)	132,939	6,211,762	1,196,787	-	-	7,397,612
Depreciation	-	-	-	-	-	6,260,111	6,260,111
Scholarships and fellowships	13,965	-	16,049	-	1,075,662	-	1,105,676
Auxiliary enterprises	3,478,053	896,840	8,657,129	1,848,684	1,164,395	-	16,045,101
Other operating expenses	-	-	23,436	-	-	-	23,436
Total	$ 30,632,604	$ 9,174,375	$27,132,755	$ 3,596,181	$ 2,801,713	$ 6,260,111	$79,597,739

11. COMMITMENTS

As of June 30, 2004, the University was a party to construction contracts totaling approximately $15,827,301, of which $12,625,091 was incurred as of June 30, 2004.

12. RETIREMENT PLANS

Virginia Retirement System

Employees of the University are employees of the Commonwealth of Virginia. Substantially all full-time classified salaried employees of the University participate in a defined benefit retirement plan administered by the Virginia Retirement System (VRS). VRS is an agent multiple-employer public employee retirement system (PERS) that acts as a common investment and administrative agency for the Commonwealth of Virginia and its political subdivision.

The VRS does not measure assets and pension benefit obligations separately for individual state institutions. Therefore, all information relating to this plan is available at the statewide level in the Commonwealth's CAFR. The CAFR discloses the unfunded pension benefit obligation at June 30, 2004, as well as the ten-year historical trend information showing VRS' progress in accumulating sufficient assets to pay benefits when due.

The University's payroll costs for employees covered by the VRS for the year ended June 30, 2004, were $20,715,787. The University's total payroll costs for the year then ended was $30,632,604. The University's total VRS contributions were $1,915,432 for the year ended June 30, 2004, which included the five percent employee contribution assumed by the employer. These contributions represent 9.2 percent of covered payroll for the year.

Optional Retirement Plans

Full-time faculty and certain administrative staff may participate in six optional retirement plans. University employees currently participate in four of these plans, which include: Fidelity Investments Institutional Services, Teacher Insurance and Annuity Association/College Retirement Equity Fund, T. Rowe Price and Associates, and Variable Annuity Life Insurance. These are fixed-contribution programs where the retirement benefits received are based upon the employer and employee contributions totaling 10.4 percent, plus interest and dividends.

Individual contracts issued under these plans provide full and immediate vesting of both the University and the participants' contributions. Total pension costs under these plans were approximately $660,226 for the year ended June 30, 2004. Contributions to the optional retirement programs were calculated using the base salary amount of approximately $6,348,327. The University's total payroll in fiscal year 2004 was approximately $30,632,604.

13. POST-EMPLOYMENT BENEFITS

The Commonwealth participates in the VRS-administered statewide group life insurance programs, which provides post-employment life insurance benefits to eligible retired and terminated employees. The Commonwealth also provides health care credits against the monthly health insurance premiums of its retirees who have at least 15 years of service and participate in the state's health plan. Information relating to these plans is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

14. SPECIAL TERMINATION BENEFITS

Full-time faculty and certain administrative staff participated in Early Retirement Incentive Plan (ERIP) and Alternate Severance Options/Workforce Transition Act (ASO/WTA) through the University in fiscal year 2004. At June 30, 2004, total ERIP payments were $329,342 for fiscal year 2004, $39,627 for fiscal year 2005; and $1,000 for fiscal year 2006. ASO/WTA payments totaled $278,986 for fiscal year 2004 and $452,660 for fiscal year 2005.

15. CONTINGENCIES

The University has received federal grants for specific purposes that are subject to review and audit by the grantor agencies. Claims against these resources are generally conditional upon compliance with the terms and conditions of grant agreements and applicable federal regulations, including the expenditure of resources for allowable purposes. Any disallowance resulting from a federal audit may become a liability of the University.

In addition, the University is required to comply with various regulations issued by the Office of Management and Budget. Failure to comply with these regulations may result in questions concerning the allowability of related direct and indirect charges pursuant to such agreements. As of June 30, 2004, the University estimates that no material liabilities will result from such audits or questions.

The University has been a defendant in several legal actions. The final outcome is unpredictable at this time, but management is of the opinion that the liability, if any, for these legal actions will not have a material effect on the University's financial position.

16. RISK MANAGEMENT

The University is exposed to various risks of loss related to torts, theft, or damage to and destruction of assets, errors, and omissions, non-performance of duty, injuries to employees, and natural disasters. The University participates in insurance plans maintained by the Commonwealth of Virginia. The state employee health care and workers' compensation plans are administered by the Department of Human Resource Management and the risk management insurance plans are administered by the Department of Treasury, Division of Risk Management. Risk management insurance includes property, general liability, medical malpractice, faithful performance of duty bond, automobile, and air and watercraft plans. The University pays premiums to each of these Departments for its insurance coverage. Information relating to the Commonwealth's insurance plans is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

17. PENDING GASB STATEMENT

GASB Statement 40, *Deposit and Investment Risk Disclosures*, issued March 2003, will be effective for the fiscal year ending June 30, 2005. This Statement addresses common deposits and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, GASB 40 requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in the Statement must also be disclosed.

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SUPPLEMENTARY INFORMATION

VIRGINIA STATE UNIVERSITY
SCHEDULE OF AUXILIARY ENTERPRISES REVENUES AND EXPENDITURES
For the Year Ended June 30, 2004

	Food Service	Bookstore	Residential Facilities	Parking and Transportation
Revenues:				
Student fees	$ 4,433,762	$ -	$ 6,205,495	$ -
Sales and services	349,235	241,611	95,905	274,760
Interest	-	-	-	-
Miscellaneous revenue	-	-	-	38
Other	-	-	672	6,149
Rental fees	-	-	155,854	-
Total revenues	4,782,997	241,611	6,457,926	280,947
Operating expenditures:				
Personal services	-	-	789,582	17,554
Employee benefits	-	-	192,356	35,370
Total personal services and benefits	-	-	981,938	52,924
Other than personal services:				
Contractual services	2,683,432	945	1,173,711	(50,656)
Supplies and materials	23,689	-	14,687	(2,142)
Property and improvement	-	-	-	-
Equipment	10,527	300	678,012	375
Current charges and obligations	14,061	-	20,621	14,510
Scholarships	-	249	410,622	-
Transfer payments	-	-	(1,844)	-
Unemployment compensation	-	-	2,004	-
Indirect cost	623,814	360	714,168	2,660
Individual claims and settlement	-	-	-	-
Miscellaneous	-	2,780	-	17,293
Total other than personal services	3,355,523	4,634	3,011,981	(17,960)
Total operating expenditures	3,355,523	4,634	3,993,919	34,964
Excess (deficiency) of revenues over (under) operating expenditures before transfers	1,427,474	236,977	2,464,007	245,983
Tranfers to other funds:				
Mandatory transfers-debt service	(75,000)	-	-	(206,203)
Nonmandatory transfers	(788,774)	(143,211)	(1,810,339)	105,740
Net increase (decrease)	563,700	93,766	653,668	145,520
Fund balance at beginning of year	357,528	13,058	495,516	281,646
Fund balance at end of year	$ 921,228	$ 106,824	$ 1,149,184	$ 427,166

Telecom-munication	Student Health Services	Student Unions and Recreational Facilities	Other Auxiliary Functions	Intercollegiate Athletics	Reserves	Total
$ -	$ -	$ -	$ 9,042,622	$ 276,470	$ -	$ 19,958,349
74,936	13,730	43,814	102,440	292,186	-	1,488,617
-	-	-	229,699	-	-	229,699
94	-	-	9,386	160	-	9,678
2,254	17	2,544	4,069	5,192	-	20,897
-	-	-	35,930	-	-	191,784
77,284	13,747	46,358	9,424,146	574,008	-	21,899,024
78,603	275,964	632,757	815,176	640,971	-	3,250,607
23,869	70,919	120,356	265,026	138,508	-	846,404
102,472	346,883	753,113	1,080,202	779,479	-	4,097,011
(117,001)	76,163	241,410	412,614	403,908	-	4,824,526
4,186	23,363	29,248	439,126	188,842	-	720,999
-	-	-	-	-	-	-
40,452	3,037	25,602	91,066	106,627	-	955,998
-	2,431	15,936	844,166	79,732	-	991,457
-	-	21,682	252,089	501,226	-	1,185,868
-	-	(340)	79	3,449	-	1,344
-	-	38	1,204	1,996	-	5,242
5,347	110,007	258,606	633,249	346,893	-	2,695,104
-	-	-	-	-	-	-
-	-	-	52,445	220	-	72,738
(67,016)	215,001	592,182	2,726,038	1,632,893	-	11,453,276
35,456	561,884	1,345,295	3,806,240	2,412,372	-	15,550,287
41,828	(548,137)	(1,298,937)	5,617,906	(1,838,364)	-	6,348,737
-	-	-	-	2,167	(1,443,966)	(1,723,002)
-	584,148	1,247,162	(4,353,542)	2,037,599	975,591	(2,145,626)
41,828	36,011	(51,775)	1,264,364	201,402	(468,375)	2,480,109
2,118	49,273	12,356	757,222	49,654	5,470,973	7,489,344
$ 43,946	$ 85,284	$ (39,419)	$ 2,021,586	$ 251,056	$ 5,002,598	$ 9,969,453

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Commonwealth of Virginia

Auditor of Public Accounts
P.O. Box 1295
Walter J. Kucharski, Auditor
Richmond, Virginia 23218

April 15, 2005

The Honorable Mark R. Warner
Governor of Virginia

The Honorable Lacey E. Putney
Chairman, Joint Legislative Audit
and Review Commission

Board of Visitors
Virginia State University

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the accompanying basic financial statements of **Virginia State University**, a component unit of the Commonwealth of Virginia, and its aggregate discretely presented component units as of and for the year ended June 30, 2004, as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the component units of the University, which are discussed in Note 1. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates the amounts included for the component units of the University is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the component units of the University that were audited by other auditors upon whose reports we are relying were audited in accordance with auditing standards generally accepted in the United States of America, but not in accordance with Government Auditing Standards. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the University and of its aggregate discretely presented component units as of June 30, 2004, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in the notes to the financial statements, the University has implemented the provisions of Governmental Accounting Standards Board Statement No.39, *Determining Whether Certain Organizations are Component Units,* which addresses the conditions under which institutions should include associated foundations as component units and how such component units should be displayed in the financial statements.

The "Management's Discussion and Analysis" is on pages 5 through 14 is not a required part of the basic financial statements, but is supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements of the University. The Schedule of Auxiliary Enterprises – Revenues and Expenditures is presented for the purpose of additional analysis and is not a required part of the basic financial statements. The schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statement taken as a whole.

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the University's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the section titled "Internal Control and Compliance Findings and Recommendations."

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

Compliance and Other Matters

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

Status of Prior Findings

The University has not taken adequate corrective action with respect to the previously reported finding "Improve Contract Administration." Accordingly, we included this finding in the section entitled "Internal Control and Compliance Findings and Recommendations." The University has taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this report.

The "Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters" is intended solely for the information and use of the Governor and General Assembly of Virginia, the Board of Visitors, and management, and is not intended to be and should not be used by anyone, other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

EXIT CONFERENCE

We discussed this report with management at an exit conference held on June 3, 2005.

AUDITOR OF PUBLIC ACCOUNTS

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VIRGINIA STATE UNIVERSITY

PETERSBURG, VIRGINIA 23806
(804) 524-5995
(804) 524-5347 FAX
ccone@vsu.edu

Vice President for Administration & Finance

TDD (804) 524-5487

June 21, 2005

Mr. Walter Kucharski
Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218-1295

RE: Response to Audit Comments

Dear Mr. Kucharski:

Virginia State University thanks you for the opportunity to respond to the Internal Controls and Audit Findings presented in the audit report for the year ended June 30, 2004; and in accordance with Government Auditing Standards, we are providing the following responses for inclusion in your published report.

We also appreciate the auditor's acknowledgement of the improvements made since the prior year audit and value the advice and support your staff has provided to the University over the years. We look forward to the auditor's continued guidance and consultations afforded to our staff.

Improve Contract Administration

The University concurs that competent contract administration is critical to ensure satisfactory completion of contract requirements. The following actions have occurred or are planned to ensure proper contract administration:

1. Existing policies and procedures that address contract monitoring have been strengthened to address points identified in the audit findings.

2. Effective January 2005, contract administrator duties for major outsourced projects have been re-assigned from Purchasing to avoid having the same individual both administer the contract and approve contract modifications.

3. The University has identified the need and is planning to institute formal "contract administration" training for all designated employees beginning September 2005.

4. The annual contract review form will be improved to include a more extensive review of the contract to coincide with all aspects of the scope of work, inclusive of reporting and delivery requirements.

Document Policies and Procedures

Financial Reporting
The University understands the importance of having written procedures to strengthen its internal controls over accounting processes. To this end, the documentation of procedures is an ongoing process at the University. As new tasks come online they are documented as to how they are to be performed and the individuals who are to perform them. The procedures are then shared with pertinent staff. The University plans to undertake an effort to centralize procedures in a more formal setting so that when transition occurs these procedures will improve the training process for new or transferred employees. The area of Administration and Finance has also hired an expert to help formalize desk procedures. These procedures will incorporate the preparation of the financial statements and year-end journal entries.

Human Resources
The University has adopted and applied the procedures for human resources and payroll processing as outlined in the respective manuals and guidance documents authored by the Department of Human Resource Management and the Department of Accounts for processing terminated employees, managing wage employees, performing monthly reconciliations, and certifying payroll. The University plans to document the specifics of how these formal Commonwealth procedures are applied at Virginia State University.

Removal of Account Access
The University has procedures and directions to remove all unnecessary suspended accounts from the University's systems. Further, the University will investigate all system attributes, and recommend where possible, to comply with the suggested industry best practices for strong password controls for all systems. The University will establish and implement procedures to monitor compliance with this policy university wide. A Chief Information Officer position has been created to increase oversight and monitoring of all information technology and system processes and provide accountability to senior management.

Improve Reconciliation Process

The University understands and places great emphasis on the importance of performing timely reconciliations for its local bank accounts. As noted by APA, the University experienced severe staff turnover and position vacancies during the fiscal year. These vacancies hindered the reconciliation process and resulted in some delay in completing the reconciliation. However, despite turnovers in key positions related to the reconciliations area, staff demonstrated heightened awareness of the need to safeguard the University's assets and ensure fundamental controls through the maintenance of up-to-date reconciliations throughout the fiscal year. As of April 15, 2005 reconciliations through March 2005 were complete. Management is taking steps to fill all vacant positions to ensure the accuracy of financial information, timely completion of reconciliations, and a strong internal control environment.

Improve Documentation of System Changes

The University will modify its procedures to ensure that there is sufficient documentation of software and hardware change management. Logs will be created to provide an audit trail for each change. The audit trail will show the appropriate approval, provide assurance of the systems or network's integrity and provide a documented appropriate plan when required. Management will periodically review to monitor compliance with this procedure.

Improve User Account Management and Password Controls to Critical Systems

The University will ensure that documentation is received and maintained in accordance with its policies and procedures for user access. The University will also strengthen its controls over password requirements and settings such that they meet the standards established by industry best practices.

The University is committed to addressing these findings as expeditiously as possible. We appreciate the ongoing assistance and cooperation of your staff as we work to improve internal controls and the efficiency of our operations.

Sincerely,

Clementine S. Cone

Clementine S. Cone
Vice President for Administration and Finance

c: Dr. Eddie N. Moore, Jr., President
Mr. David A. Moll, State Comptroller
The Honorable Belle S. Wheelan, Secretary of Education
Mr. Richard D. Brown, Director, Department of Planning and Budget

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