# Virginia College Savings Plan

Annual Report for the Period Ended
June 30, 2004

# -TABLE OF CONTENTS-

## MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)

The Virginia College Savings Plan's Management Discussion and Analysis is required supplemental information under the Governmental Accounting Standards Board (GASB) reporting model. It is designed to assist the reader in focusing on significant financial issues and provides an overview of financial activity. This discussion includes an analysis of the Plan's financial condition and results of operations for the fiscal year ended June 30, 2004. Since this presentation includes summarized data, it should be read in conjunction with the accompanying financial statements and notes.

The Virginia College Savings Plan (the Plan) operates the Commonwealth's Internal Revenue Code (IRC) Section 529 qualified tuition program, which offers three options, the Virginia Prepaid Education Program (VPEP), the Virginia Education Savings Trust (VEST), and CollegeAmerica. VPEP is considered a defined benefit plan which offers contracts, for actuarially determined amounts, guaranteeing full future tuition and mandatory fee payments at the Commonwealth's higher education institutions and differing payouts at private or out-of-state institutions. Annually, the Plan's actuary determines the actuarial soundness of VPEP. Key factors used in the soundness analysis include potential tuition increases (both short and long-term) as well as anticipated investment performance.

VEST is a defined contribution program which allows participants to make contributions into their selected investment portfolio(s). VEST accounts are subject to market investment risk, including the possible loss of principal. CollegeAmerica is also a defined contribution plan which offers 21 different American Funds mutual fund products as investment options. CollegeAmerica participants also bear all market risk for their investment, including the potential loss of principal. The American Funds acts as program manager for this program and provides all back office and operational activities for the program.

### Financial Highlights

- VPEP cash, cash equivalents, and investments increased by $210 million, or 35.5 percent, due to continued investment in the program by existing participants as well as extremely favorable market conditions.
- VPEP's actuarially determined tuition benefits payable liability decreased by $20.1 million which was primarily due to the actual depletion of account benefits through normal usage during the academic year. New enrollment in fiscal year 2004 was limited to newborns. All enrollment was suspended effective December 31, 2003. Therefore, the program incurred no appreciable new liability.
- VPEP's total net assets increased by $104.2 million to a deficit of $128.3 million as compared to a deficit $232.5 million in the prior year.
- VEST net assets held in trust for program participants increased by $147 million or about 54 percent, which was due to accelerated investor participation and improved market conditions.
- CollegeAmerica net assets held in trust for program participants more than doubled over the previous year to $7.1 billion, due to the unprecedented popularity of the program. CollegeAmerica remained the largest IRC Section 529 program in the nation at June 30, 2004.

## Overview of Financial Statements

This discussion and analysis is an introduction to the Plan's basic financial statements, which includes the Plan's business-type activity or enterprise fund, the fiduciary or private purpose trust funds, and the notes to the financial statements.

<u>Business-Type Activity</u>

All VPEP activities are accounted for in an enterprise fund, which is used to account for governmental operations that are financed and operated in a manner similar to a private sector business. Enterprise funds report activities that charge fees for supplies or services to the general public. This activity is reported on the full accrual basis of accounting. This means that all revenue and expenses are reflected in the financial statements even if the related cash has not been received or paid as of June 30.

The Statement of Net Assets presents information on all VPEP assets and liabilities, with the difference between the two reported as total net assets. Over time, increases and decreases in net assets indicate whether VPEP's financial position is improving or deteriorating.

The Statement of Revenues, Expenses, and Changes in Net Assets presents the revenues earned and expenses incurred during the year, including both actual as well as actuarially determined contributions from participants and distributions for higher education expenses.

The Statement of Cash Flows presents information related to cash inflows and outflows summarized by operating, financing, and investing activities.

<u>Fiduciary Funds</u>

VEST and CollegeAmerica are reported as private purpose trust funds. Private purpose trust funds account for transactions of trust arrangements in which the principal and income benefit individuals, private organizations or other governments, and use the full accrual basis of accounting. The activities of the Plan's private purpose trust funds are reported in the Statement of Fiduciary Net Assets and the Statement of Changes in Fiduciary Net Assets.

<u>Notes to the Financial Statements</u>

The notes provide additional information that is essential to a full understanding of the data provided in the financial statements.

## Analysis of Enterprise Fund Financial Activities

VPEP's net liabilities exceeded assets by $128.3 million during the fiscal year. Table 1 reflects the condensed Statement of Net Assets for fiscal year 2004 compared to fiscal year 2003.

Table 1
Statement of Net Assets as of June 30, 2004 and 2003
(dollars in millions)

| | 2004 | 2003 |
|---|---|---|
| Current assets | $ 160.0 | $ 212.4 |
| Investments | 703.6 | 510.6 |
| Other noncurrent assets | 169.9 | 224.1 |
| Total assets | 1,033.5 | 947.1 |
| Current liabilities | 48.9 | 46.2 |
| Noncurrent liabilities | 1,112.9 | 1,133.4 |
| Total liabilities | 1,161.8 | 1,179.6 |
| Net assets: | | |
| Invested in capital assets | 0.2 | 0.2 |
| Unrestricted | (128.5) | (232.7) |
| Total net assets | $ (128.3) | $ (232.5) |

Overall the net assets increased by approximately $104.2 million.

Current assets decreased primarily due to the $72.8 million decrease in the current tuition contributions receivable. This represents the decrease in the actuarially determined amount expected to be collected from contract holders of record during the next fiscal year. Had there been an enrollment period during the fiscal year, the receivable projection would have increased as in prior years. However, new enrollment was suspended throughout much of the fiscal year. Therefore, both current and noncurrent contributions receivable decreased normally as participants continued to make scheduled or accelerated payments. This decrease in contributions receivable was offset somewhat by an increase in cash and cash equivalents of $17.3 million, an increase in investments held by the Treasurer of $1.8 million, and increased interest and accounts receivables totaling $1.3 million. Increased cash and cash equivalents may be attributed to the short-term investment decisions made by selected VPEP investment managers who elected to hold highly liquid investments at year end. Also, the Plan elected to hold additional funds in the general account of the Commonwealth throughout the fiscal year, making these additional funds available to the Treasurer for securities lending transactions. This resulted in the increase in the line item investments held by the Treasurer.

Investments increased by $193 million, or approximately 37.8 percent, due in part to strong investment performance during the fiscal year. In addition, tuition contributions remained consistent with the prior year due to continued strong participation by existing contract holders.

Other noncurrent assets decreased by $54.2 million, or 24.2 percent, primarily due to the decrease in the noncurrent portion of the tuition contributions receivable. Again, this represents the decrease in the actuarially determined amount expected to be collected from contract holders of record in future years.

The total tuition benefits payable decreased by $20.1 million and reflects the change in the actuarial present value of the future tuition obligation. Changes in the present value of the future tuition benefit obligation include the changes in the present value discount due to the passage of time, differences between actual experience and the actuarial assumptions used, and any changes in actuarial assumptions. The program incurred no appreciable new liability from new contracts. Therefore, the decrease was consistent with the depletion and/or normal usage of existing contract benefits.

During fiscal year 2004, VPEP's actuarial deficit position, as calculated by the Plan's actuary and reported in the 2004 Actuarial Valuation Report, improved by $104.2 million, from a deficit of $232.6 million to a deficit of $128.4 million. This improvement is mostly attributable to lower than expected tuition increases, an investment gain, and changes in the actuarial assumption used in performing the actuarial valuation. Average tuition rates for the 2004-2005 academic year increased approximately 10.5 percent for universities and 6.6 percent for community colleges, which was below the 15 percent rate assumed in the prior valuation. This resulted in an actuarial gain of $54.8 million.

The return on investments for the fiscal year was 16 percent on a time-weighted basis and 14.6 percent on a dollar-weighted basis. For the June 30, 2003 actuarial valuation, a 6.75 percent return was assumed. This produced a net actuarial gain of approximately $53.2 million.

The two most significant assumptions in the valuation are the rate of investment return and future tuition growth. The 2004 valuation projects an expected rate of return on investments of 7 percent, which represents a 0.25 percent increase from the 6.75 percent investment return assumption used in the prior year's valuation. This change decreased the actuarial deficit by $20.3 million. The tuition growth assumption was changed from 15 percent for one year and 6 percent thereafter to 10 percent for one year, 8 percent for two years, and 7 percent thereafter for university tuition, and from 15 percent for one year and 9 percent thereafter to 7 percent for all years for community college tuition. This increased the present value of obligations and the actuarial deficit by $20.5 million.

The Plan received administrative fee revenue from all the Plan's programs, including CollegeAmerica. This decreased the deficit by $7.9 million. In addition, it was projected that the actuarial deficit would grow during the year by approximately $15.7 million due to the passage of time. This is due to the calculation of the obligations as present values which grow with interest with the passage of time.

The overall effect of the changes on the actuarial reserve (deficit) are summarized in the following table. Please note that the 2004 Actuarial Valuation Report may be obtained from the Plan.

Table 2
(amounts in millions)

| | |
|---|---|
| Actuarial reserve (deficit) at June 30, 2003 | $ (232.6) |
| Tuition gain (loss) | 54.8 |
| Investment gain (loss) | 53.2 |
| Change in investment return assumption | 20.3 |
| Change in tuition growth assumption | (20.5) |
| Administrative Fee Revenue from VCSP | 7.9 |
| Interest on prior deficit at 6.75% | (15.7) |
| Miscellaneous | 4.2 |
| Actuarial reserve (deficit) at June 30, 2004 | $ (128.4) |

Table 3 reflects a condensed Statement of Revenues, Expenses, and Changes in Net Assets for fiscal year 2004 as compared to the prior year.

Table 3
Statement of Revenues, Expenses, and Changes
in Net Assets for June 30, 2004 and 2003
(dollars in millions)

| | 2004 | 2003 |
|---|---|---|
| Operating revenues: | | |
| Interest and dividends | $ 27.5 | $ 12.7 |
| Net increase (decrease) of fair value of investments | 70.7 | 22.2 |
| Tuition contributions | 1.4 | 194.3 |
| Other | 7.9 | 4.6 |
| Total operating revenue | 107.5 | 233.8 |
| Operating expenses: | | |
| Personal services | 2.3 | 2.4 |
| Contractual services | 1.5 | 2.0 |
| Tuition benefits expense | (1.1) | 403.6 |
| Other | 0.5 | 0.3 |
| Total operating expenses | 3.2 | 408.3 |
| Operating income (loss) | 104.3 | (174.5) |
| Transfer to Commonwealth | (0.1) | (0.1) |
| Change in net assets | 104.2 | (174.6) |
| Net assets – beginning | (232.5) | (57.9) |
| Net assets – ending | $ (128.3) | $ (232.5) |

Interest and dividends and the net increase (decrease) in fair value of investments increased primarily due to the improvement of market conditions throughout the fiscal year. This resulted in an increase in revenue collections as well as an increase in the actual market value of most equity investments at June 30, 2004.

Tuition contributions decreased by $192.9 million from the prior year. This decrease is directly attributable to the suspension of new enrollment throughout the fiscal year. In previous years, new contract sales resulted in an increase in actual contributions received at the time applications were submitted as well as a significant increase in the annual accrual of tuition contributions receivable. Therefore, with no new enrollment during the fiscal year, tuition contributions decreased as anticipated.

Tuition benefits expense also decreased significantly from the previous year and is reflected as a negative expense item in the table above. This negative amount represents the difference between actual distributions made to higher education institutions on behalf of program participants and the amount accrued for estimated expenses, which is determined by the actuarial valuation. As noted previously, the Plan incurred no appreciable new liability from new contracts during the fiscal year. Therefore, the estimated expenses accured in this fiscal year reflected only the estimated reduction in liability for existing contracts.

Table 4 reflects the condensed Statement of Cash Flows.

Table 4
Statement of Cash Flows for June 30, 2004 and 2003
(dollars in millions)

| | 2004 | 2003 |
|---|---|---|
| Cash provided (used) by: | | |
| Operating activities | $ 112.2 | $ 116.5 |
| Noncapital financing activity | (0.1) | (0.1) |
| Investing activities | (94.8) | (76.6) |
| Net increase (decrease) in cash | 17.3 | 39.8 |
| Cash – beginning of year | 81.5 | 41.7 |
| Cash – end of year | $ 98.8 | $ 81.5 |

Increases in cash from operating activities in fiscal year 2004 included an increase in contributions from participants due to early account payments/payoffs. In addition, the rapid growth of CollegeAmerica resulted in an increase in the administrative fee revenue collected from the American Funds. The Plan receives 10 basis points annually in administrative fees, which is accumulated daily and paid on a quarterly basis based on the daily market value of total assets in CollegeAmerica. However, tuition benefit payments to higher education institutions of behalf of participants increased $11.5 million and caused the overall decrease in net cash provided by operations when compared to the previous year.

The increase in the amount reflected as investing activities for 2004 is primarily due to the increase in interest income on cash, cash equivalents, and investments. This increased cash flow is the direct result of significant improvement in the equity markets during the fiscal year. In addition, six new VPEP equity investment managers began trading assets during fiscal year 2004. This resulted in an increase in both purchases and sales from investing activities.

## Analysis of Fiduciary Fund Financial Activities

Participation in the VEST program remained strong during the fiscal year. Contributions remained consistent with the prior year, with a slight increase of approximately $5.4 million. These contributions represented participation from new account holders as well as continued contributions from existing participants. Due to improved market conditions during the fiscal year, the market value of VEST assets at June 30, 2004, was much improved over the prior year. Like contributions, deductions also remained consistent as more participants withdrew funds to cover tuition expenses. The total of tuition benefits paid and shared redeemed increased by approximately $5.1 million as well.

Assets under management in CollegeAmerica, which launched February 15, 2002, increased by 108.8 percent during the fiscal year, from $3.4 billion to $7.1 billion. New unique accounts opened during the year were approximately 710,000. CollegeAmerica remained the largest broker-sold IRC Section 529 program in the country.

## Economic Factors and Outlook

The Plan continues to be cautiously optimistic that positive market conditions will continue and that actual VPEP investment performance will exceed the current actuarial assumptions. However, it is expected that tuition and fee increases at Virginia's public higher education institutions will continue to be volatile. New enrollment during the 2004 – 2005 VPEP enrollment period will increase cash and the asset base of the program but will also add to the future tuition benefit obligation of the plan. The Plan is waiting for the resolution of certain legislative proposals that may cause greater than expected tuition increases. This may lead to different future contract pricing structures or changes in future enrollment periods.

# FINANCIAL STATEMENTS

VIRGINIA COLLEGE SAVINGS PLAN
STATEMENT OF NET ASSETS - ENTERPRISE FUND
VIRGINIA PREPAID EDUCATION PROGRAM
As of June 30, 2004

| | |
|---|---|
| ASSETS | |
| Current assets: | |
| Cash and cash equivalents (Note 1D and 2) | $ 98,804,614 |
| Investments held by treasurer (Note 3) | 2,835,560 |
| Interest receivable | 2,173,046 |
| Tuition contributions receivable (Note 1E) | 54,500,000 |
| Accounts receivable (Note 1F) | 1,701,041 |
| Total current assets | 160,014,261 |
| Noncurrent assets: | |
| Investments (Note 1D and 2) | 703,607,085 |
| Tuition contributions receivable (Note 1E) | 169,711,617 |
| Depreciable capital assets, net (Note 1G and 6) | 162,245 |
| Total noncurrent assets | 873,480,947 |
| Total assets | 1,033,495,208 |
| LIABILITIES | |
| Current liabilities: | |
| Accounts payable | 926,543 |
| Due to program participants (Note 1H) | 133,155 |
| Obligations under securities lending (Note 3) | 2,835,560 |
| Tuition benefits payable (Note 5) | 44,900,000 |
| Compensated absences (Note 1I and 5) | 100,720 |
| Total current liabilities | 48,895,978 |
| Noncurrent liabilities: | |
| Tuition benefits payable (Note 5) | 1,112,811,617 |
| Compensated absences (Note 1I and 5) | 67,399 |
| Total noncurrent liabilities | 1,112,879,016 |
| Total liabilities | 1,161,774,994 |
| NET ASSETS | |
| Invested in capital assets, net of related debt | 162,245 |
| Unrestricted (Note 9) | (128,442,031) |
| Total net assets | $ (128,279,786) |

The accompanying notes are an integral part of this financial statement.

VIRGINIA COLLEGE SAVINGS PLAN
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
ENTERPRISE FUND - VIRGINIA PREPAID EDUCATION PROGRAM
For the Fiscal Year Ended June 30, 2004

| | |
|---|---|
| Operating revenues: | |
| Charges for sales and services | $ 7,890,122 |
| Interest, dividends, rents, and other investment income | 27,523,839 |
| Net increase in fair value of investments | 70,738,330 |
| Tuition contributions (Note 7) | 1,422,290 |
| Total operating revenues | 107,574,581 |
| Operating expenses: | |
| Personal services | 2,313,376 |
| Contractual services | 1,501,151 |
| Supplies and materials | 51,050 |
| Depreciation | 71,419 |
| Rent, insurance, and other related charges | 206,426 |
| Tuition benefits expense (Note 7) | (1,136,224) |
| Expendable equipment | 183,031 |
| Other | 25,126 |
| Total operating expenses | 3,215,355 |
| Operating income | 104,359,226 |
| Transfers: | |
| Transfers to the General Fund of the Commonwealth | (103,467) |
| Change in net assets | 104,255,759 |
| Net assets - July 1, 2003 | (232,535,545) |
| Net assets - June 30, 2004 | $ (128,279,786) |

The accompanying notes are an integral part of this financial statement.

VIRGINIA COLLEGE SAVINGS PLAN
STATEMENT OF CASH FLOWS
ENTERPRISE FUND - VIRGINIA PREPAID EDUCATION PROGRAM
For the Fiscal Year Ended June 30, 2004

| | |
|---|---|
| Cash flows from operating activities: | |
| Receipts for sales and services | $ 7,055,899 |
| Payments to suppliers for goods and services | (448,137) |
| Payments to employees | (2,295,442) |
| Tuition contributions received | 128,513,019 |
| Payments for contractual services | (1,477,258) |
| Tuition benefit payments | (19,117,553) |
| Other operating payments | (1,090) |
| Net cash provided by (used for) operating activities | 112,229,438 |
| Cash flows from noncapital financing activities: | |
| Transfer to the General Fund of the Commonwealth | (103,467) |
| Net cash provided by (used for) noncapital financing activities | (103,467) |
| Cash flows from capital and related financing activities: | |
| Acquisition of fixed assets | (68,430) |
| Net cash provided by (used for) capital and related financing activities | (68,430) |
| Cash flows from investing activities: | |
| Purchase of investments | (1,489,205,072) |
| Proceeds from sales or maturities of investments | 1,366,970,331 |
| Interest income on cash, cash equivalents, and investments | 27,468,815 |
| Net cash provided by (used for) investing activities | (94,765,926) |
| Net increase in cash and cash equivalents | 17,291,615 |
| Cash and cash equivalents - July 1, 2003 | 81,512,999 |
| Cash and cash equivalents - June 30, 2004 | $ 98,804,614 |

VIRGINIA COLLEGE SAVINGS PLAN
STATEMENT OF CASH FLOWS - ENTERPRISE FUND
VIRGINIA PREPAID EDUCATION PROGRAM (continued)
For the Fiscal Year Ended June 30, 2004

| | | |
|---|---|---|
| Reconciliation of operating income to net cash provided by operating activities: | | |
| Operating income | $ | 104,359,226 |
| Adjustments to reconcile operating income to net cash provided by (used for) operating activities: | | |
| Depreciation | | 71,419 |
| Interest, dividends, rents and other investment income | | (27,468,815) |
| Net increase in fair value of investments | | (70,738,330) |
| Changes in assets and liabilities: | | |
| (Increase) decrease in receivables | | (1,277,699) |
| (Increase) decrease in tuition contributions receivable | | 126,968,630 |
| Increase (decrease) in accounts payable | | 435,823 |
| Increase (decrease) in amounts due to program participants | | (52,008) |
| Increase (decrease) in current tuition benefits payable | | 500,000 |
| Increase (decrease) in current compensated absences | | 24,475 |
| Increase (decrease) in noncurrent tuition benefits payable | | (20,568,630) |
| Increase (decrease) in noncurrent compensated absences | | (24,653) |
| Net cash provided by (used for) operating activities | $ | 112,229,438 |
| Noncash investing, capital, and financing activities: | | |
| The following transaction occurred prior to the statement of net assets date: | | |
| Change in fair value of investments | $ | 70,738,330 |

The accompanying notes are an integral part of this financial statement.

VIRGINIA COLLEGE SAVINGS PLAN
STATEMENT OF FIDUCIARY NET ASSETS -
PRIVATE-PURPOSE TRUST FUNDS
As of June 30, 2004

| | Virginia Education Savings Trust | CollegeAmerica | Total |
|---|---|---|---|
| Assets: | | | |
| Cash and cash equivalents (Note 1D and 2) | $ 3,006,741 | $ - | $ 3,006,741 |
| Receivables: | | | |
| Contributions | 245,034 | - | 245,034 |
| Interest and dividends | 312,418 | - | 312,418 |
| Investments: (Note 1D and 2) | | | |
| Mutual funds | 217,438,001 | 7,130,840,465 | 7,348,278,466 |
| Index funds | 107,425,897 | - | 107,425,897 |
| Guaranteed investment contracts | 61,309,326 | - | 61,309,326 |
| Common stock | 29,339,470 | - | 29,339,470 |
| Total investments | 415,512,694 | 7,130,840,465 | 7,546,353,159 |
| Total assets | 419,076,887 | 7,130,840,465 | 7,549,917,352 |
| Liabilities: | | | |
| Accounts payable | 127,441 | - | 127,441 |
| Due to program participants (Note 1H) | 7,760 | - | 7,760 |
| Total liabilities | 135,201 | - | 135,201 |
| Net assets held in trust for program participants | $ 418,941,686 | $ 7,130,840,465 | $ 7,549,782,151 |

The accompanying notes are an integral part of this financial statement.

VIRGINIA COLLEGE SAVINGS PLAN
STATEMENT OF CHANGES IN FIDUCIARY NET ASSETS -
PRIVATE-PURPOSE TRUST FUNDS
For the Fiscal Year Ended June 30, 2004

| | Virginia Education Savings Trust | CollegeAmerica | Total |
|---|---|---|---|
| Additions: | | | |
| Contributions: | | | |
| From participants | $ 132,921,296 | $ 3,411,646,704 | $ 3,544,568,000 |
| Charges for services | 928,073 | - | 928,073 |
| Investment income: | | | |
| Net increase in fair value of investments | 28,429,513 | 637,699,688 | 666,129,201 |
| Interest, dividends, and other investment income | 12,211,675 | 90,356,020 | 102,567,695 |
| Total investment income | 40,641,188 | 728,055,708 | 768,696,896 |
| Less investment expenses | (2,326,996) | (7,635,960) | (9,962,956) |
| Net investment income | 38,314,192 | 720,419,748 | 758,733,940 |
| Total additions | 172,163,561 | 4,132,066,452 | 4,304,230,013 |
| Deductions: | | | |
| Tuition benefits paid | 19,101,876 | 89,047,111 | 108,148,987 |
| Shares redeemed | 5,098,737 | 266,846,854 | 271,945,591 |
| Administrative expenses | 927,823 | 5,245,152 | 6,172,975 |
| Total deductions | 25,128,436 | 361,139,117 | 386,267,553 |
| Net increase | 147,035,125 | 3,770,927,335 | 3,917,962,460 |
| Net assets held in trust for program participants: | | | |
| July 1, 2003 | 271,906,561 | 3,359,913,130 | 3,631,819,691 |
| June 30, 2004 | $ 418,941,686 | $ 7,130,840,465 | $ 7,549,782,151 |

The accompanying notes are an integral part of this financial statement.

# NOTES TO FINANCIAL STATEMENTS

VIRGINIA COLLEGE SAVINGS PLAN

NOTES TO FINANCIAL STATEMENTS

AS OF JUNE 30, 2004

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Virginia College Savings Plan (the Plan), an independent agency of the Commonwealth of Virginia, was created in 1994 by the Virginia General Assembly and its enabling legislation is codified at §23-38.75 through §23-38.87 of the Code of Virginia, as amended. The Plan operates the Commonwealth's IRC §529 qualified tuition program, which offers three options, the Virginia Prepaid Education Program (VPEP), the Virginia Education Savings Trust (VEST), and CollegeAmerica.

VPEP is a defined benefit program, which offers contracts, for actuarially determined amounts, guaranteeing full future tuition and mandatory fee payments at Virginia higher education institutions. The contract provisions also allow benefits to be used at private or out-of-state institutions with a payout based on the amounts charged by Virginia's higher education institutions. VPEP has a limited enrollment period each year, and is open to children in the ninth grade or younger if the child or participant is a Virginia resident. During the seven enrollment periods to date, over 67,900 accounts have been opened, with approximately 58,000 contracts remaining active at year-end. The program had contributions and net earnings of approximately $802 million as of June 30, 2004. The program invests contract payments to meet future obligations. Operating costs are paid from program earnings. The Plan does not receive any general fund appropriations. The program's assets and income are exempt from federal, state, and local income taxation. Legislation was passed in 1998 to provide a financial guarantee to cover VPEP contractual obligations in the event of a funding shortfall.

VEST is a defined contribution program, which allows participants of all ages to save for qualified higher education expenses, including tuition and fees, at any qualified higher education institution by making contributions into the investment portfolio(s) of their choice. New participants are allowed to select from among 11 investment portfolios. A twelfth portfolio is still actively traded in the VEST program but is closed to new participation. The VEST program, which is open year round, has no age or residency restrictions, and carries no legislative guarantee of return of principal. VEST accounts are subject to market investment risk, including the possible loss of principal. VEST began operation in December 1999. As of June 30, 2004, over 53,700 accounts have been opened with a net asset value of approximately $419 million. Investment management fees and VEST operating expenses are paid on a pro-rata basis by each VEST account owner and vary according to the portfolio selected. VEST accounts provide investors with the same federal and state tax benefits available to participants in the prepaid program.

In 2001, the Board of the Virginia College Savings Plan entered into a 15-year contract with Capital Research and Management Company, American Funds Distributors, Inc., and American Funds Service Company, Inc. (together, the American Funds) to administer a broker-sold IRC §529 college savings option using 21 of the American Funds. This program, called CollegeAmerica, is a defined contribution plan which launched on February 15, 2002. The American Funds acts as program manager and provides all back office and operational activities for the program. As a result of this structure, the Plan's staff has minimal day-to-day administrative responsibility, other than program oversight and review.

Like VEST, CollegeAmerica allows participants of all ages to save for qualified higher education expenses by selecting from among the 21 offered funds. CollegeAmerica is available year round, has no age or residency restrictions, and carries no legislative guarantee of return of principal. Accounts are subject to market risk, including the possible loss of principal. As of June 30, 2004, approximately 710,000 unique accounts had been opened with net assets in excess of $7.1 billion. (A unique account represents all accounts with the same contributor and beneficiary combination.) Fees and expenses of the program are also paid on a pro-rata basis by each account owner and vary according to the fund and share class selected. CollegeAmerica provides investors with the same federal and state tax benefits available to participants in VPEP and VEST.

While CollegeAmerica activity is reflected in total in this report, a separate audited report for each of the 21 funds offered in the CollegeAmerica program is published annually by the American Funds. Each of the funds has a different year ending date, so these audited reports are published throughout the year. An individual fund audit report includes that fund's results for all share classes offered in the fund, including the five IRC §529 share classes created for the CollegeAmerica program. These individual fund reports are available from the American Funds.

An eight-member Board administers the Plan, consisting of four members who sit on the Board by virtue of the state offices they hold and four citizen members appointed by the Governor. The ex-officio members are the Executive Director of the State Council of Higher Education for Virginia, the Chancellor of the Virginia Community College System, the State Treasurer, and the State Comptroller. State law mandates that the four citizen members have significant experience in finance, accounting, and investment management.

A separate report is prepared for the Commonwealth of Virginia, which includes all agencies, boards, commissions, and authorities over which the Commonwealth exercises or has the ability to exercise oversight authority. The Plan is an integral part of the reporting entity of the Commonwealth of Virginia and is included in the basic financial statements of the Commonwealth.

The following is a summary of significant accounting policies employed by the Virginia College Savings Plan.

A. Basis of Presentation

The accompanying financial statements have been prepared in conformance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Account Standards Board (GASB) and the Financial Accounting Standards Board (FASB).

B. Reporting Entity

The accompanying financial statements report the financial position, and the changes in financial position and cash flows of the Plan as of and for the fiscal year ended June 30, 2004. For financial reporting purposes, the Plan includes all funds and entities over which the Plan exercises or has the ability to exercise oversight authority.

C. Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The Plan reports the activity of the Virginia Prepaid Education Program as an enterprise fund, which is a type of proprietary fund. Enterprise funds account for transactions related to resources received and used for financing self-supporting activities of the Plan that offer products and services on a user-charge basis to external users. All operating expenses and all administrative fee revenue collected to support Plan operations, including administrative revenue and expenses of VEST and CollegeAmerica, are reflected in the enterprise fund.

The Plan reports the activity of the Virginia Education Savings Trust and CollegeAmerica as private-purpose trust funds, which is a type of fiduciary fund. Private-purpose trust funds account for transactions of trust arrangements in which the principal and income benefit individuals, private organizations, or other governments.

The financial statements of the proprietary and fiduciary funds are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recognized when a liability is incurred, regardless of the timing of related cash flows.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. Revenues and expenses not meeting this definition are reported as nonoperating. The principal operating revenues of the Plan are tuition contributions for program participants and investment income. Operating expenses of the plan include tuition benefits expense and contractual and personal services.

GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, provides governments two options for using proprietary fund activities. All proprietary funds reported herein apply all applicable Governmental Accounting Standards Board pronouncements and all Financial Accounting Standards Board Statements and Interpretations, Accounting Principle Board Opinions, and Accounting Research Bulletins issued on or before November 30, 1989, unless they conflict with or contradict GASB pronouncements.

D. Cash Equivalents and Investments

Money market investments of the Plan, which are deemed short-term, highly liquid investments, are reported at amortized cost. Long-term investments of the Plan are recorded at fair value based upon quoted market prices. Cash equivalents are investments with an original maturity of three months or less.

The Plan also participates in the Commonwealth's General Account pool, which is managed by the State Treasurer. These pooled investments are valued on an amortized cost basis. The Plan receives income on a quarterly basis from the Commonwealth based on the Plan's relative participation during the quarter. The Plan receives no additional distribution of unrealized gains or losses in the fair values of the pool's investments.

E. Tuition Contributions Receivable

Tuition contributions receivable in VPEP represents the actuarially determined present value of future payments anticipated from contract holders.

F. Accounts Receivable

Accounts receivable reflected in VPEP include the amount due from the American Funds for second quarter administrative fees collected on behalf of the Plan from the CollegeAmerica program. The American Funds pays the Plan an annual fee equal to one tenth of one percent (.10 percent) of the average daily net asset value of the underlying funds held in CollegeAmerica. This fee is accrued daily and paid to the Plan on a quarterly basis.

G. Capital Assets

Fixed assets are capitalized and depreciated on a straight-line basis over their useful lives. Fixed assets are valued at historical cost. The Plan capitalizes all property, plant, and equipment that have a cost or value greater than $5,000 and an expected useful life of greater than two years; however, all computer equipment is capitalized regardless of cost or value. Equipment currently owned by the Plan has an estimated useful life of five years.

H. Amounts Due To Program Participants

Amounts due to program participants reflects amounts due to participants who cancelled or overpaid prepaid tuition contracts or savings trust accounts prior to June 30, 2004, but had not yet received a refund.

I. Accrued Leave Policy

Employees accrue annual leave at a rate of four to nine hours semi-monthly, depending on their length of service. The maximum accumulation is dependent upon years of service, but in no case may it exceed 42 days. All employees leaving the agency are paid for accrued vacation leave up to the maximum calendar year limit at their current earnings rate.

In conformance with Section C60 of GASB Codification, the monetary value of accumulated annual leave payable upon termination is included in the accompanying financial statements. The liability at June 30, 2004, was computed using salary rates effective at that date and represents vacation and compensatory leave earned up to the allowable ceilings. In accordance with GASB Statement No. 16, *Accounting for Compensated Absences*, included in the liability is the agency's share of FICA taxes on leave balances for which employees will be compensated.

Employees of the Plan have elected to participate in the Virginia Sickness and Disability Program. The Virginia Retirement System (VRS) administers the program to provide income protection for absences due to sickness or disability from the first day on the job. After a seven calendar-day waiting period following the first incident of disability, eligible employees receive short-term disability benefits ranging from 60 to 100 percent of compensation up to a maximum of 125 work days, based upon months of State service. After a 180 calendar-day waiting period (125 work days of short-term disability) eligible employees receive long-term disability benefits equal to 60 percent of compensation until they return to work, until age 65, or until death. Employees enrolled in this program are not eligible for disability retirement benefits under the VRS.

All State agencies are required to contribute to the cost of providing disability benefits. Initial contribution requirements to fund the program were determined by the VRS actuary based on an estimate of the amount of the liability for disability benefits that would transfer from VRS to the new program. The contribution requirement was 1.07 percent of payroll for State employees. Further information about this program can be found in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

2. CASH, CASH EQUIVALENTS, AND INVESTMENTS

The Board of the Virginia College Savings Plan has full power to invest funds in accordance with §23-38.80 of the Code of Virginia, as amended. This section requires the Board to discharge its duties in a manner which will provide the investment return and risk level consistent with the actuarial return requirements and cash flow demands of the Plan and conforming to all statutes governing the investment of Plan funds. The Board shall exercise the judgment of care under the circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but to the permanent disposition of funds, considering the probable income as well as the probable safety of their capital when investing funds. In order to meet the return requirements, the Plan's portfolio shall be invested in a broadly diversified portfolio of domestic and foreign stocks, bonds, and cash equivalent investments, which are defined as investments with an original maturity of three months or less. The Board's allocation target for the overall VPEP portfolio, at market value, is 50 percent investment in equity securities and 50 percent investment in fixed income instruments. The Board's allocation targets for the VEST program vary according to the investment objective of each portfolio. To assist in with the investment of the Plan assets, the Board has selected a group of 16 external managers and/or funds. In addition, the Plan has monies invested by the State Treasurer as part of the Commonwealth's General Account for both VPEP and VEST.

The Board authorized its partner, the American Funds, to offer 21 of their mutual funds to investors in CollegeAmerica. The Board has oversight and review authority for the investment activity and operations of the CollegeAmerica program. The American Funds is required to seek renewed approval of the use of these mutual funds on an annual basis.

Investments held in the VPEP, VEST, and CollegeAmerica programs at June 30, 2004, have been categorized according to the level of credit risk associated with its custodial arrangements at fiscal year end. Credit risk refers to the risk that the Plan may not be able to obtain possession of its investments in the event of default by a counterparty. Category 1 includes investments that are insured or registered or for which securities are held by the Plan or its agent in the Plan's name. Category 2 includes uninsured and unregistered investments for which securities are held by the counterparty's trust department or agent in the Plan's name. Category 3 includes uninsured and unregistered investments for which securities are held by the counterparty, or by its trust department or agent, but not in the Plan's name. Certain investments cannot be categorized because they are not evidenced by physical securities. VPEP investments, reported in the enterprise fund at June 30, 2004, were categorized as follows.

| | Fair Value |
|---|---|
| Category 1: | |
| U.S. Treasury and agency securities | $ 80,367,309 |
| Common and preferred stocks | 290,389,464 |
| Corporate and other bonds | 96,109,453 |
| | |
| Non-categorized: | |
| Mutual, Money Market Funds | 171,490,552 |
| Index Funds | 61,967,365 |

| | |
|---|---|
| Guaranteed Investment Contracts | 62,331,218 |
| Fixed Income/Commingled Funds | 29,848,880 |
| State Treasurer General Account Investment Pool | 9,907,458 |
| Total cash equivalents and investments | $802,411,699 |

Investment holdings of the VEST and CollegeAmerica programs, reported as private-purpose trust funds, were categorized as follows.

| | Fair Value |
|---|---|
| Category 1: | |
| Common and preferred stocks | $ 29,339,470 |
| Non-categorized: | |
| Mutual, Money Market Funds | 7,350,505,796 |
| Index Funds | 107,425,897 |
| Guaranteed Investment Contracts | 61,309,326 |
| State Treasurer General Account Investment Pool | 779,411 |
| Total cash equivalents and investments | $7,549,359,900 |

3. SECURITIES LENDING TRANSACTIONS

Investments held by the Treasurer of Virginia represent the Plan's allocated share of securities 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 Comprehensive Annual Financial Report.

4. OPERATING LEASES

The Plan leases satellite office facilities in West Chester, PA as a disaster recovery site as well as office space for the Plan's newly created information technology division, College Savings Systems, under an operating lease. While the disaster recovery site became operational in fiscal year 2004, the new division was not staffed or operational at year-end. Total costs for this lease were $22,845 for the year ended June 30, 2004. The future minimum lease payments for this lease are as follows:

| Year Ending June 30 | Amount |
|---|---|
| 2005 | $ 25,662 |
| 2006 | 26,435 |
| 2007 | 2,203 |
| Total future minimum lease payments | $ 54,300 |

5. LONG-TERM LIABILITIES

Long-term liabilities of the Plan include tuition benefits payable, which represents the actuarially determined present value of future obligations anticipated for payment of benefits and administrative expenses for the Virginia Prepaid Education Program. Also, reflected in the enterprise fund are the accrued compensated absences for the Plan's employees.

| Enterprise Fund | Balance July 1, 2003 | Increases | Decreases | Balance June 30, 2004 | Due Within One Year |
|---|---|---|---|---|---|
| Compensated absences | $ 168,297 | $ 111,137 | $ 111,315 | $ 168,119 | $ 100,720 |
| Tuition benefits payable | 1,177,780,247 | - | 20,068,630 | 1,157,711,617 | 44,900,000 |
| Total | $1,177,948,544 | $ 111,137 | $22,286,328 | $1,157,879,736 | $45,000,720 |

6. CAPITAL ASSETS

The following schedule presents capital asset activity of the Plan for the year ended June 30, 2004.

| Enterprise Fund | July 1, 2003 | Increases | Decreases | June 30, 2004 |
|---|---|---|---|---|
| Depreciable capital assets: | | | | |
| Equipment | $ 355,567 | $ 68,430 | $ - | $ 423,997 |
| Less accumulated depreciation for: | | | | |
| Equipment | 190,333 | 71,419 | - | 261,752 |
| Total depreciable capital assets, net of accumulated Depreciation | $ 165,234 | $ (2,989) | $ - | $ 162,245 |

7. TUITION CONTRIBUTIONS AND TUITION BENEFITS EXPENSE

The tuition contributions and the tuition benefits expense line items represent the annual accrual of contributions and distribution expenses determined by the actuarial valuation and adjusted by the actual activity for the fiscal year. In fiscal year 2004, new enrollment was suspended. Therefore, there was no accrual of new contributions to be collected or expenses from new liabilities. The actuarially determined amounts decreased normally as participants continued to make scheduled or accelerated contributions and depleted and/or used existing contract benefits. The tuition benefits expense amount of ($1.1) million is the result of the actual depletion/usage of contract benefits during the fiscal year being less than the projected expense based on the actuarial valuation.

8. RETIREMENT AND PENSION PLAN

Employees of the Plan are employees of the Commonwealth of Virginia. The employees participate in a defined benefit pension plan administered by the Virginia Retirement System (VRS). The VRS also administers life insurance for employees and retirees. Information relating to these plans is available at the statewide level only in the Commonwealth of Virginia's Comprehensive Annual Financial Report. The Commonwealth, not the Plan, has overall responsibility for determining contributions to these plans.

9. DEFICIT NET ASSETS (ENTERPRISE FUND)

The deficit net assets amount at June 30, 2004, reflected in the enterprise fund represents the projected unfunded actuarial liability calculated for the fiscal year by the Plan's actuary. While the Plan remains in a deficit position, there was significant improvement over the prior year deficit, which was reduced from $232.5 million to the current $128.3 million. This represents a 44.8% positive change in position. This improvement is primarily attributable to lower than expected tuition increases for the 2004-2005 academic year and to actual returns on the Plan's investments exceeding the assumed rate of return by a substantial margin. Offsetting the positive movement, however, was the negative impact caused by the change in the future tuition growth assumption.

The Board will continue to address this issue by working with the VPEP actuary and investment consultant to continually monitor the investment allocation and determine if there should be any additional diversification or expansion into other investment strategies in order to enhance long-term investment returns. It remains the Board's intention to reduce the actuarial deficit over time by creating an actuarial reserve and implementing appropriate premium pricing in any future enrollment periods. However, it is expected that tuitions at Virginia's public higher education institutions will continue to be volatile.

10. RISK MANAGEMENT

The Virginia College Savings Plan 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 Plan participates in insurance plans maintained by the Commonwealth of Virginia. The state employee health care and worker's 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 Plan 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.

11. VIRGINIA COLLEGE DREAM FOUNDATION

The Virginia College Dream Foundation (VCDF) is a private, non-profit 501(c)(3) scholarship foundation founded in 1997. The VCDF enables individuals, organizations, community groups, corporations, and trusts to make charitable contributions, which are then used to purchase VPEP tuition and fee contracts and to open VEST accounts for at-risk youth. The mission of the VCDF is to work with community partners to make the dream of college a reality for deserving youth in Virginia and to create a model for helping at-risk students through state-sponsored college savings programs nationwide.

At June 30, 2004, the VCDF owned 55 VPEP contracts and 40 VEST accounts.

Commonwealth of Virginia

Walter J. Kucharski, Auditor

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

October 29, 2004

The Honorable Mark R. Warner
Governor of Virginia

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

Board Members
Virginia College Savings Plan

INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying financial statements of the enterprise fund, which is a major fund, and the private-purpose trust funds of the **Virginia College Savings Plan** (Plan) as of and for the year ended June 30, 2004, which collectively comprise the Plan's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Plan's management. Our responsibility is to express opinions on these financial statements based on our audit.

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. 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 provides a reasonable basis for our opinions.

As discussed in Note 1, the basic financial statements of the Plan are intended to present the financial position and the changes in financial position and cash flows of only that portion of the business-type activities, major enterprise fund, and aggregate remaining fund information of the Commonwealth of Virginia that is attributable to the transactions of the Plan. They do not purport to, and do not, present fairly the Commonwealth of Virginia's overall financial position as of June 30, 2004, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the enterprise fund and private-purpose trust funds of the Virginia College Savings Plan 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.

The "Management's Discussion and Analysis" on pages one through seven 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.

In accordance with Government Auditing Standards, we have also issued our report dated October 29, 2004, which includes our consideration of the Plan's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

AUDITOR OF PUBLIC ACCOUNTS

SAH:whb

VIRGINIA COLLEGE SAVINGS PLAN
Richmond, Virginia

BOARD MEMBERS
As of June 30, 2004

Julie Cox, Chairman

David A. Von Moll, Vice-Chairman

Jody M. Wagner, Secretary/Treasurer

Glenn DuBois

Nancy Cooley

Geary Davis

Frank M. Conner III

Cindy M. Roberts

EXECUTIVE DIRECTOR

Diana F. Cantor