American Education Services

AES/PHEAA

Annual Financial Report
June 30, 2004

PHEAA
Creating Access to Education

This discussion and analysis of the financial performance of Pennsylvania Higher Education Assistance Agency is required supplementary information. It introduces the basic financial statements and provides an analytical overview of our financial activities. Please read it in conjunction with the financial statements that follow this discussion.

We are a public corporation and government instrumentality created by the Pennsylvania General Assembly and our mission is to improve higher education opportunities for Pennsylvanians. Doing business as American Education Services, we provide financial aid services serving students, families, schools, lenders, and other student financial aid providers. To fulfill our mission we distribute grants; originate, purchase, and sell student loans; guarantee student loans; service student loans; and provide information technology services. To serve Pennsylvanians effectively, we operate both inside and outside Pennsylvania.

Instead of using taxpayer money to support our administration, we manage our business activities to deliver financial aid as well as to provide additional public service benefits. Annually through our programs, we provide over $99 million of support to higher education.

The following table highlights public service benefits we currently provide.

For the year ended June 30 (in thousands)		2004	2003
Origination fees paid on behalf of borrowers	$	**29,005**	24,955
Guaranty fees waived on behalf of borrowers		**27,117**	23,329
Armed Forces Loan Forgiveness Program		**7,803**	-
Costs of operating state and federal governmental programs		**15,716**	16,863
Funding and support of The Pennsylvania Higher Education Foundation, Inc.		**11,085**	10,452
Other public service activities and outreach		**8,633**	6,386
	$	**99,359**	81,985

Under the Keystone family of loan programs, we provide a Keystone Stafford loan for Pennsylvania students with family incomes of less than $21,000. We pay all three of the federally required origination points and waive the 1% guaranty fee for these students. Additionally we provide a 2% interest rate reduction after 36 consecutive on-time payments.

We also provide a KeystoneBEST loan for other students. For these loans, we also pay all three of the federally required origination points and waive the 1% guaranty fee. We provide a 2% interest rate reduction after 48 consecutive on-time payments.

Through the Armed Forces Loan Forgiveness program, we forgive up to $2,500 of student loan principal to borrowers who served in the armed forces in an active duty status since September 11, 2001.

We have also developed other programs including:

- Nursing Loan Forgiveness for Healthier Futures program through which we forgive up to $12,500 or 25% of eligible student loan principal over three years of qualifying employment at a participating Pennsylvania healthcare facility or participating Pennsylvania postsecondary educational institution.

- Quality Early Education Loan Forgiveness program through which we forgive up to $3,300 per year for up to three years for qualified child care employees.

- Academic Excellence Scholarship Award through which we provide grants of $1,500 for Pennsylvanians who have both high academic potential and demonstrated financial need.

We administer various grant programs to help students pursuing higher education. The most significant programs are funded by the Commonwealth of Pennsylvania and are as follows:

- The State Grant Program provides grants up to $3,300 to students based upon financial need.

- The Institutional Assistance Grants Program provides grants to independent postsecondary education institutions to make sure both public and independent postsecondary institutions are viable in the Commonwealth.

- The New Economy Technology Scholarship Program provides financial assistance grants up to $3,000 to students enrolled in a postsecondary science or technology program approved by the Pennsylvania Department of Education.

- The Matching Funds program provides financial assistance to higher education institutions to assist them in capturing federal funds that require a state or local match as part of the federal grant award.

We also support The Pennsylvania Higher Education Foundation, Inc., ("PHEF") which is a tax-exempt organization that supports postsecondary education. PHEF created the Nursing Education Grant Program and disbursed $5.4 million of grants during its most recent fiscal year.

Finally, we fund other public service and outreach initiatives to make sure that persons are aware of the financial aid opportunities available to them and to avert student loan defaults.

As part of our guaranty operations, we manage the Federal Student Loan Reserve Fund ("Federal Fund") for the U.S. Department of Education ("ED"). The Federal Fund is primarily used to pay claims on defaulted loans.

Our operations involved in originating, purchasing, selling, guaranteeing, and servicing student loans generally operate under the Federal Family Education Loan Program ("FFELP") although we also originate, purchase, and service loans that are privately insured. FFELP is the federal program that allows undergraduate or graduate students at eligible postsecondary schools to obtain low-cost loans.

Currently, there are four types of FFELP loans:

- Subsidized Stafford – the federal government pays the interest on these loans while the student is in school, during the grace period, and during deferments.
- Unsubsidized Stafford – the student is responsible for all interest.
- Parent Loan for Undergraduate Students ("PLUS") – supplemental loans to parents.
- Consolidation – loans that allow borrowers to combine Stafford and certain other education-related loans, fix the rate of interest, and extend the repayment period.

The interest rate charged to the borrower varies based upon the type of loan and regulations in effect at the time that the loan was originated.

ED also makes special allowance payments. These payments generally result in the loan yield to the lender being higher than the rate charged to borrowers and the loan yield being variable regardless of whether the rate paid by the borrower is variable or fixed. The amount of special allowance payments also varies based upon the type of loan and regulations in effect at the time that the loan was originated. The minimum special allowance payment rates for loans made on or after October 1, 1980 and financed with proceeds from tax-exempt obligations issued before October 1, 1993 effectively provide an overall minimum return of 9.5% on those loans.

FFELP regulations require up-front origination fees of 3% to be deducted from the proceeds of student loans and remitted to the federal government. We currently pay all of the up-front fees for loans originated by us. For loans serviced by us for other lenders, we pay one of the three up-front origination points. The cost of providing these benefits is reported with grants and other financial aid.

For our guaranty activities, the federal government pays us loan processing and issuance fees when new loans that we guarantee are disbursed. The federal government also pays us portfolio maintenance fees for managing the outstanding portfolio of guaranteed loans.

Our major function as a guarantor is to guarantee principal and interest repayment to lenders if the borrower fails to pay the loan. Under federal regulations, we must manage the Federal Fund so that there is enough money to pay lenders when their normal collection efforts fail. The federal government reinsures the Federal Fund, and reinsurance rates vary based upon default rates of our portfolio of guaranteed loans and based upon the date the loan was disbursed as follows:

- Disbursed before October 1, 1993 — 80% – 100%
- Disbursed between October 1, 1993 and September 30, 1998 — 78% – 98%
- Disbursed on or after October 1, 1998 — 75% – 95%

Our default rate has always been at a level that allowed us to receive the maximum reinsurance rate. We may charge a guarantee fee of up to 1% when we guarantee a loan; however, we currently do not charge a fee. If we would charge a fee, the proceeds would go into the Federal Fund.

After a loan defaults, we continue to try to collect the amounts and are allowed to retain up to 23% of the amounts collected as revenue. The remaining amount is returned to the federal government.

We also receive default aversion fees as an incentive to help us prevent defaults. These fees are paid from the Federal Fund and must be repaid if the loan defaults in the future.

In the past, we have also originated and purchased student loans related to another federally sponsored program – the Health Education Assistance Loan ("HEAL") Program. Under the HEAL program, borrowers pay interest at a quarterly reset variable-rate based upon the 91-day U.S. Treasury Bill plus a spread of up to 3%. The actual limit on the spread in effect for an individual loan is based upon the contract in effect with the U.S. Department of Health and Human Services at the time the loan was originated.

Forward-looking Statements

This financial report contains statements relating to future results that are considered "forward-looking statements." These statements relate to, among other things, risk-sharing losses, servicing losses, simulation of changes in interest rates, litigation results, changes in law and regulations, and the adoption of new accounting standards. These forward-looking statements are based on assumptions that involve risks and uncertainties and that are subject to change based on various important factors (some of which are beyond our control). Actual results may differ materially from those expressed or implied as a result of these risks and uncertainties, including, but not limited to, interest rate fluctuations; changes in political and economic conditions; competitive product and pricing pressures within our markets; market fluctuations; the effects of adopting new accounting standards; inflation; technological change;

changes in law; changes in fiscal, monetary, regulatory, and tax policies and laws; success in gaining regulatory approvals when required; success in the timely development of new products and services; as well as other risks and uncertainties. Such forward-looking statements speak only as of the date on which such statements are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Description of the Basic Financial Statements

The statement of revenues, expenses, and changes in net assets reports all of our revenues and expenses. The statement measures the results of our operations.

The statement of net assets includes all of our assets and liabilities. Assets are what we own or control, and liabilities are what we owe. Net assets are what is left over after assets are used to satisfy liabilities.

The statement of cash flows supplements these statements providing relevant information about cash receipts and payments.

The notes to the financial statements are an integral part of the financial statements and contain important information necessary to get a complete view of our finances.

Condensed Financial Information

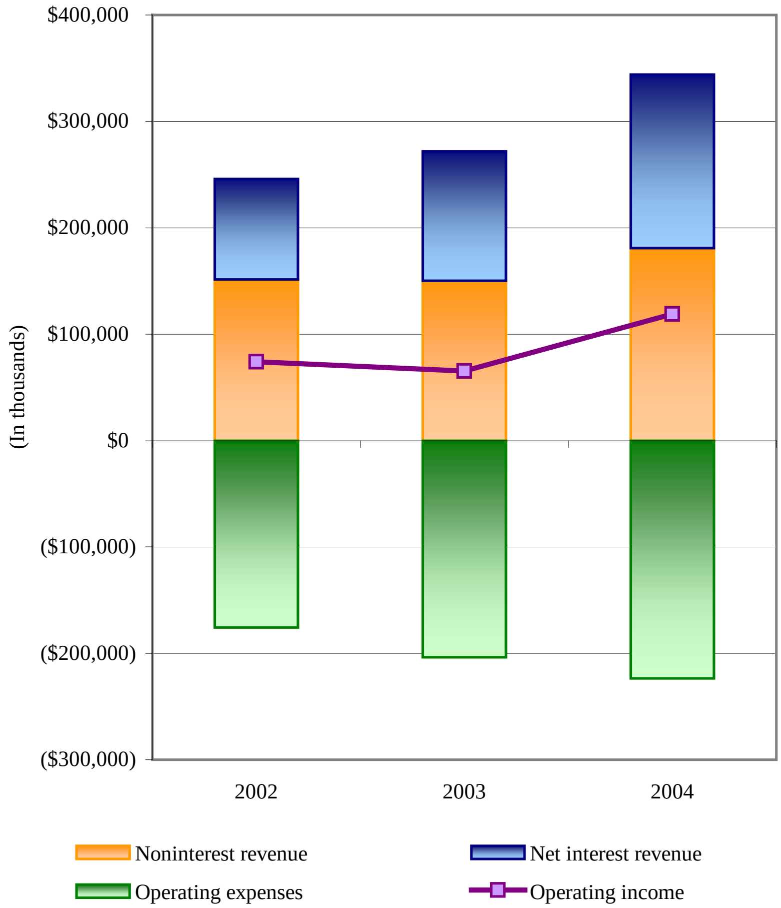
Statements of Revenues, Expenses, and Changes in Net Assets

For the years ended June 30 (in thousands)		2004	2003
Student loan interest revenue	$	**225,883**	199,820
Investment interest revenue		**13,298**	16,766
Interest expense on student loan financings and bonds payable		**(66,152)**	(82,395)
Interest expense on capital and other financings		**(9,841)**	(12,815)
Net interest revenue		**163,188**	121,376
Provision for loan losses		**(1,758)**	(2,467)
Net interest revenue after provision for loan losses		**161,430**	118,909
Servicing fees		**74,363**	66,816
Retention of collections on defaulted loans		**55,489**	44,006
Federal fees		**42,846**	34,956
Default aversion fees, net		**8,773**	3,749
Gains (losses) on student loan sales and securitizations, net		**(702)**	645
Other		**205**	189
Total noninterest revenue		**180,974**	150,361
Operating revenues		**342,404**	269,270
Operating expenses		**(223,488)**	(203,834)
Operating income		**118,916**	65,436
Commonwealth of Pennsylvania grants		**408,555**	413,552
Federal grants		**10,184**	9,354
Grants and other financial aid		**(458,290)**	(445,436)
Contributions to Pennsylvania Higher Education Foundation		**(11,085)**	(10,452)
Net income	$	**68,280**	32,454

Net Assets

At June 30 (in thousands)		**2004**	2003
Student loans receivable, net	$	**4,101,701**	4,224,887
Loans held for sale		**777,000**	-
Investments		**465,287**	526,698
Interest income receivable		**96,478**	90,943
Capital assets, net		**77,465**	74,080
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**105,328**	114,864
Other		**138,742**	113,914
Total assets		**5,762,001**	5,145,386
Notes and bonds payable, net		**5,155,627**	4,606,807
Amounts related to the Federal Student Loan Reserve Fund		**105,328**	114,864
Other		**133,275**	124,224
Total liabilities		**5,394,230**	4,845,895
Net assets			
Invested in capital assets		**3,776**	(2,160)
Restricted for debt service		**293,621**	231,844
Restricted for financial aid		**61,434**	57,309
Restricted for default aversion activities		**6,522**	8,149
Unrestricted		**2,418**	4,349
Total net assets	$	**367,771**	299,491

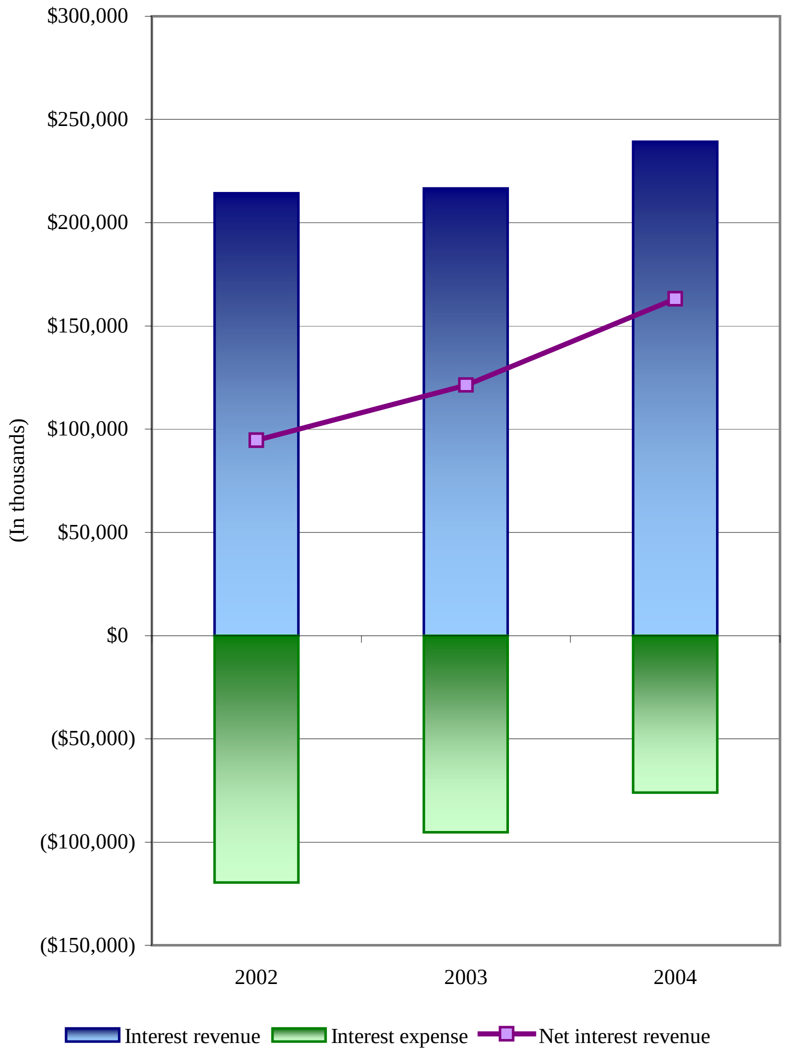
Results of Operations



Operating income for the year ended June 30, 2004 was $118.9 million, an 81.8% increase from $65.4 million in 2003. Operating revenues increased 27.1% from $269.3 million in 2003 to $342.4 million in 2004. Net interest revenue after provision for loan losses increased 35.7% from $118.9 million in 2003 to $161.4 million in 2004 because of increases in volume and changes in interest rates. Noninterest revenue increased 20.3% from $150.4 million in 2003 to $181.0 million in 2004, due to increased servicing volume, increased guaranty volume, and increased collections on defaulted loans. Operating expenses increased 9.7% from $203.8 million in 2003 to $223.5 million in 2004 due primarily to increases in personnel and increases in health benefits paid for current employees and retirees.

A more detailed explanation of these items follows.

Net Interest Revenue



Net interest revenue is created largely from our portfolio of student loans although we have investments and debt that are not related to student loans. For the year ended June 30, 2004, net interest revenue was $163.2 million, an increase of 34.4% from $121.4 million in 2003. The increase in net interest margin is explained on the following pages.

The following table shows the average rates earned on interest earning assets and the average rates paid on interest bearing liabilities.

For the years ended June 30, (balances in thousands)		**2004**		2003	
		Balances	**Rate**	Balances	Rate
Average interest earning assets					
Student loans receivable, net	$	**4,377,287**	**5.16%**	3,596,782	5.56%
Investments		**497,071**	**2.68%**	662,245	2.53%
	$	**4,874,358**	**4.91%**	4,259,027	5.09%
Average interest bearing liabilities					
Student loan financings and bonds payable		**4,435,453**	**1.49%**	3,846,371	2.14%
Other debt		**192,215**	**5.12%**	228,542	5.61%
	$	**4,627,668**	**1.64%**	4,074,913	2.34%
Net interest margin			**3.27%**		2.75%

The following table shows the net interest margin on student loans.

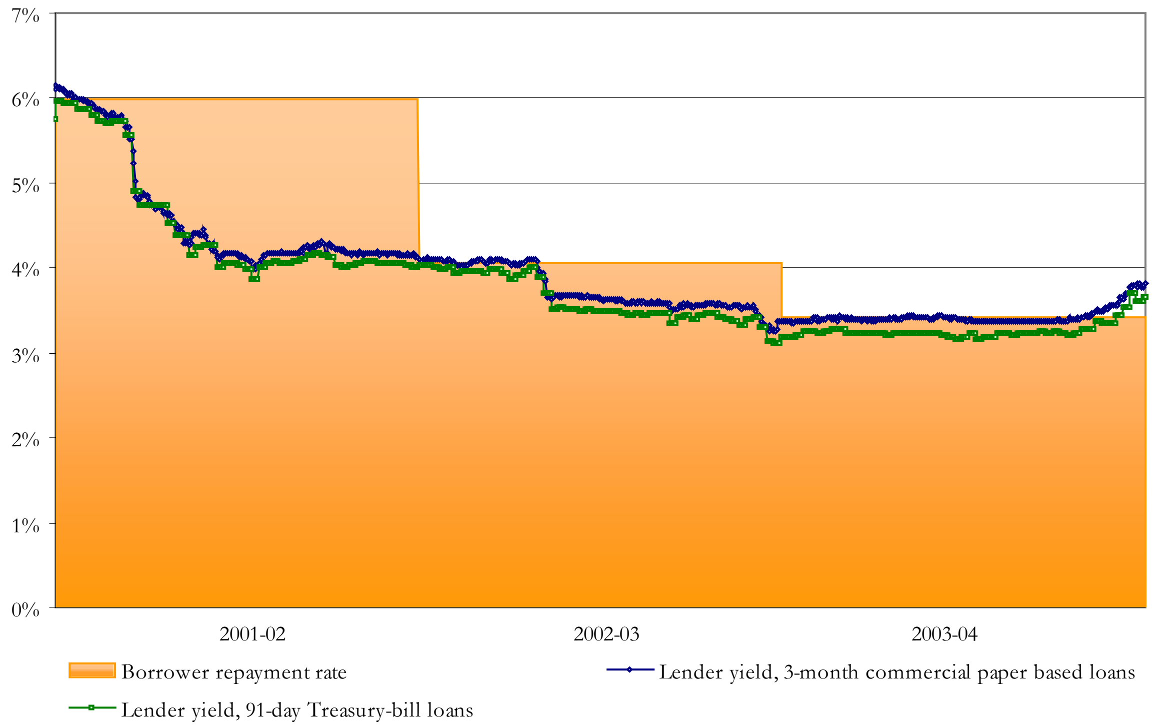
For the years ended June 30	**2004**	2003
Student loan yields	**5.94%**	6.25%
Consolidation loan rebate fees	**(0.30)**	(0.25)
Lender origination fees	**(0.06)**	(0.05)
Premium amortization	**(0.42)**	(0.39)
Student loan revenue	**5.16**	5.56
Cost of funds	**1.49**	2.14
Net interest margin on student loans	**3.67%**	3.42%

The following rate/volume analysis shows the relative contribution of changes in interest rates and changes in volumes to changes in net interest revenue.

(In thousands)		Increase (decrease)	Increase (decrease) attributable to change in Rate	Increase (decrease) attributable to change in Volume
2004 vs. 2003				
Student loan interest revenue	$	26,063	(17,298)	43,361
Investment interest revenue		(3,468)	714	(4,182)
		22,595	(16,584)	39,179
Student loan financings and bonds payable interest expense		(16,243)	(28,862)	12,619
Capital and other financings interest expense		(2,974)	(937)	(2,037)
		(19,217)	(29,799)	10,582
	$	41,812	13,215	28,597
2003 vs. 2002				
Student loan interest revenue	$	16,049	(35,086)	51,135
Investment interest revenue		(13,645)	(13,175)	(470)
		2,404	(48,261)	50,665
Student loan financings and bonds payable interest expense		(23,475)	(47,577)	24,102
Capital and other financings interest expense		(888)	(1,784)	896
		(24,363)	(49,361)	24,998
	$	26,767	1,100	25,667

While the amount that we earn on student loans involves interpreting and complying with complicated regulations issued by ED, our portfolio of student loans generally consists of variable-rate loans. 69% of the variable-rate loans, including 9.5% floor loans, change based upon changes in the 91-day U.S. Treasury Bill rate, and 31% change based upon changes in 90-day commercial paper. The rates paid by borrowers are set under a different formula and generally reset annually on July 1. As previously mentioned, ED makes special allowance payments that generally result in the loan yield to the lender being higher than the rate paid by the borrower. However, during periods that the borrower rate exceeds the rate that the lender would earn under the special allowance formula, the borrower rate becomes a floor. The following chart displays the lender yield and the borrower rate for loans in repayment.

91-day U.S. Treasury Bill Chart
July 1, 2001 through June 30, 2004



For the year ended June 30, 2004, the borrower rate exceeded the lender rate by an average 0.14% resulting in us earning $431 thousand more than would be expected based upon market conditions. In 2003, the borrower rate also exceeded the lender rate by an average 0.45%, and we earned $4.4 million more than would be expected based upon market conditions.

Average rates earned and paid by us can behave differently than market rates for the following additional reasons:

- ED regulations provide for special allowance payments that effectively provide an overall minimum return of 9.5% for student loans made after October 1, 1980 that are financed with tax-exempt debt issued through September 30, 1993. For the year ended June 30, 2004, the average balance of these loans was $1.5 billion, while the average balance was $1.2 billion in 2003.

- We have HEAL loans that reset on a one-quarter lag, so the change in market rates is not immediately reflected in the rates we earn. For the year ended June 30, 2004, the average balance was $201.3 million, while the average balance was $179.3 million in 2003.

- On July 1, 2003, we refunded $75.0 million of bonds with the proceeds from bonds issued on April 25, 2003, decreasing the effective rate from 6.05% to variable-rate bonds with a weighted average rate of 1.05% for the year ended June 30, 2004. On July 1, 2003, $312.9 million student loan revenue bonds at a weighted average rate of 2.64% fixed were changed to variable rate bonds with a weighted average rate of 1.05% for the year ended June 30, 2004.

- $150 million of bonds were refunded on July 25, 2002, decreasing the effective rate from 6.22% to variable-rate bonds with a weighted-average rate of 1.28% for the year ended June 30, 2003.

- Finally, interest rates paid on student loan financings generally are based upon the 91-day U.S. Treasury Bill; however, the rates are generally reset on a one-quarter lag. Accordingly, the change in market rates is not immediately reflected in the rates we pay.

Provision for Loan Losses

Under FFELP, 98% of principal and interest on student loans is guaranteed. The provision for loan losses represents our estimate of the costs related to the 2% risk sharing on FFELP loans we own.

In making our estimates, we consider the trend in default rates in our portfolio and changes in economic conditions. We believe the provision for loan losses is adequate to cover inherent losses in the student loan portfolio. An analysis of our allowance for loan losses is presented in the following table.

For the years ended June 30 (in thousands)		**2004**	2003
Balance at beginning of period	$	**2,000**	900
Provision for losses		**1,758**	2,467
Charge-offs		**(1,388)**	(1,367)
Balance at end of period	$	**2,370**	2,000
Allowance as a percentage of ending balance of student loans		**0.05%**	0.05%

Noninterest Revenue

Servicing Fees

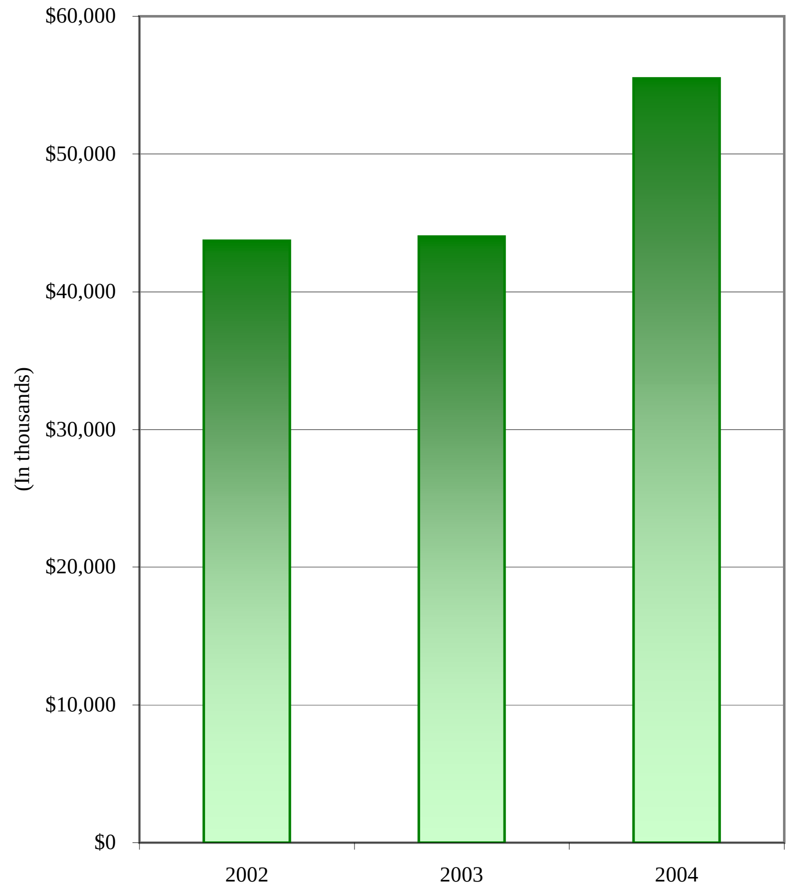
Servicing fees for the year ended June 30, 2004 were $74.4 million, an increase of 11.4% from $66.8 million in 2003. Fees increased due to increased volume of loans serviced and increases in origination and conversion billings, which were $6.6 million for the year ended June 30, 2004, compared to $5.4 million in 2003. Loans serviced by us for participating financial institutions averaged $18.9 billion in 2004 and $15.5 billion in 2003.

Fees, as a percentage of the amount of loans being serviced, are decreasing over time. The change in the rate structure is occurring because the gross loan yield earned by participating financial institutions is set by law and has repeatedly been reduced. In order for the federal student loan program to remain viable in Pennsylvania, we have had to reduce per unit servicing costs and reduce fees charged to participating financial institutions.

We also provide systems for other servicers and guarantors for a fee. For the year ended June 30, 2004, fees earned from servicing systems amounted to $5.8 million, an increase of 7.4% from $5.4 million in 2003. Loans serviced by other servicers using our systems averaged $8.5 billion in 2004, an increase of 19.7% from $7.1 billion in 2003. For the year ended June 30, 2004, fees earned from guaranty systems amounted to $862 thousand, while they were $796 thousand in 2003. Original principal amount outstanding for guarantors using our systems averaged $2.0 billion in

2004 and $1.9 billion in 2003. Fees earned from providing systems to other servicers and guarantors are included in total servicing fees discussed above.

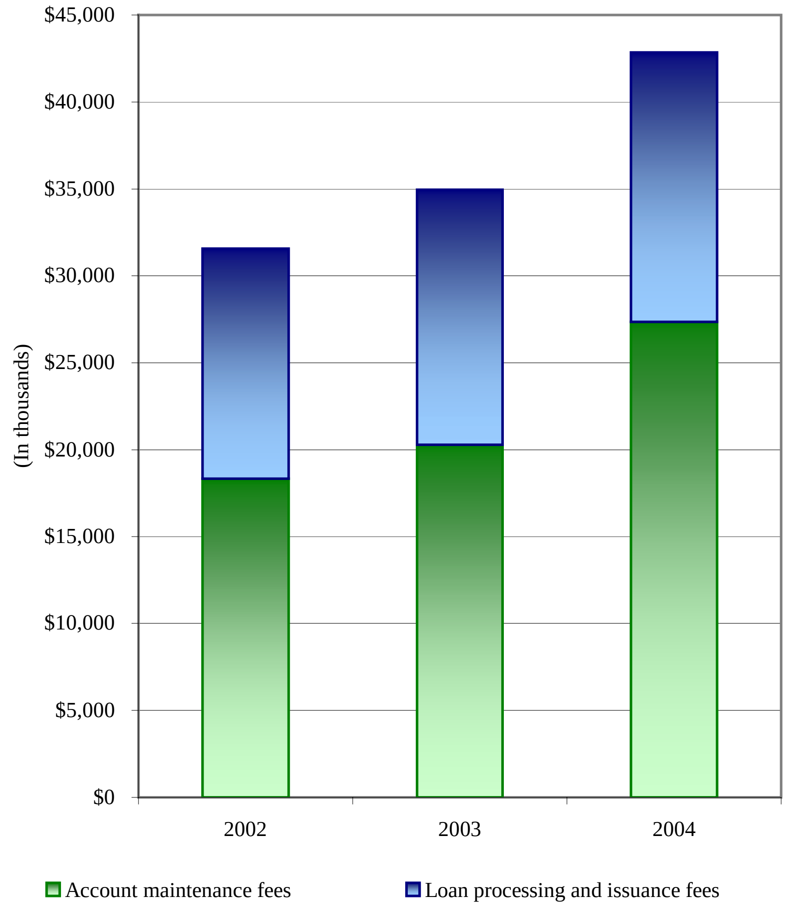
Retention of Collections on Defaulted Loans



For the year ended June 30, 2004, retention of collections on defaulted loans was $55.5 million, a 26.1% increase from $44.0 million in 2003. In addition to continued collection success, the increase is due to more aggressive pursuit of rehabilitations and direct consolidations. For the year ended June 30, 2004, the retention on rehabilitation and direct consolidation collections was $31.7 million compared to $21.2 million in 2003.

On October 1, 2003, retention of collections on defaulted loans decreased from 24% to 23%. If that new rate had been in effect for the entire year ended June 30, 2004, retention of collections on defaulted loans would have been $228 thousand less than it was in the current period.

Federal Fees

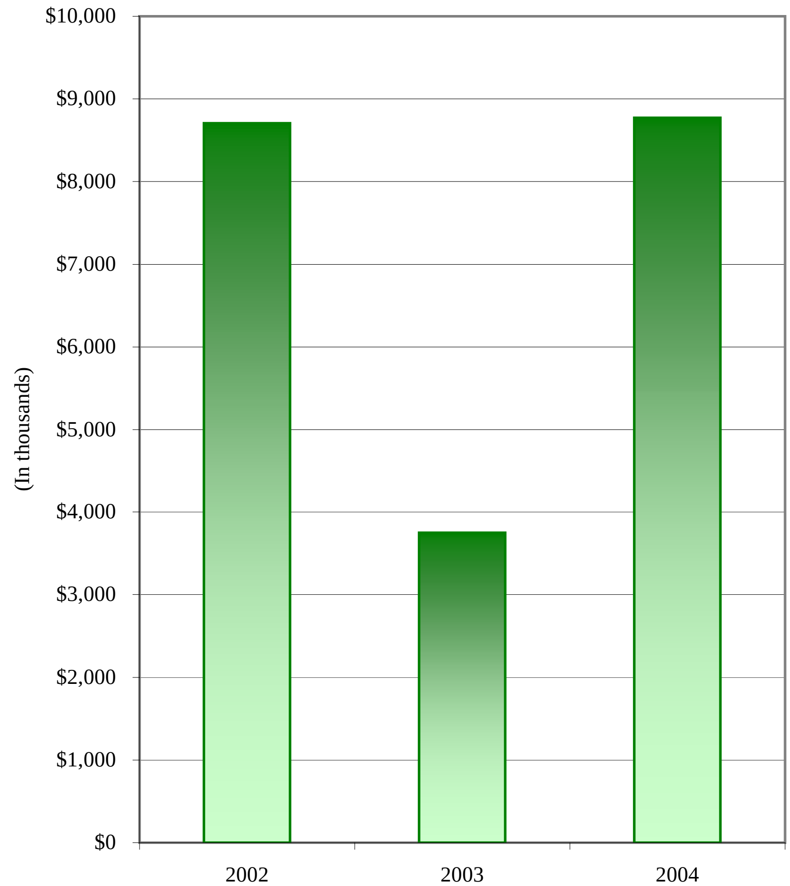


Federal fees are earned for operating the guaranty agency. Under current law, ED pays a loan processing and issuance fee that is 40 basis points for loans we guarantee as the loan is disbursed; however, the fee is not paid on new consolidation loans. Before October 1, 2003, this fee was 65 basis points. ED also pays us an annual account maintenance fee that is 10 basis points of the original principal amount of loans guaranteed as long as the guarantee remains in force.

For the year ended June 30, 2004, federal fees were $42.8 million, an increase of 22.3% from $35.0 million in 2003. The decrease due to the fee reduction discussed above was mitigated by increases in volume.

If the new rate had been in effect for the entire year ended June 30, 2004, federal fees would have been $2.1 million less than they were in the current period.

Default Aversion Fees



For the year ended June 30, 2004, default aversion fees were $8.8 million, an increase of 137.8% from $3.7 million in 2003.

This fee is earned when servicers involve guarantors to avert potential defaults and is paid from the Federal Fund. The fee may only be paid once for a loan and if the loan subsequently does default, the amount must be returned to the Federal Fund. We record an accrual for our estimate of such returns.

The increase occurred due to increased default aversion activity and a decrease in the estimate of fees to be returned.

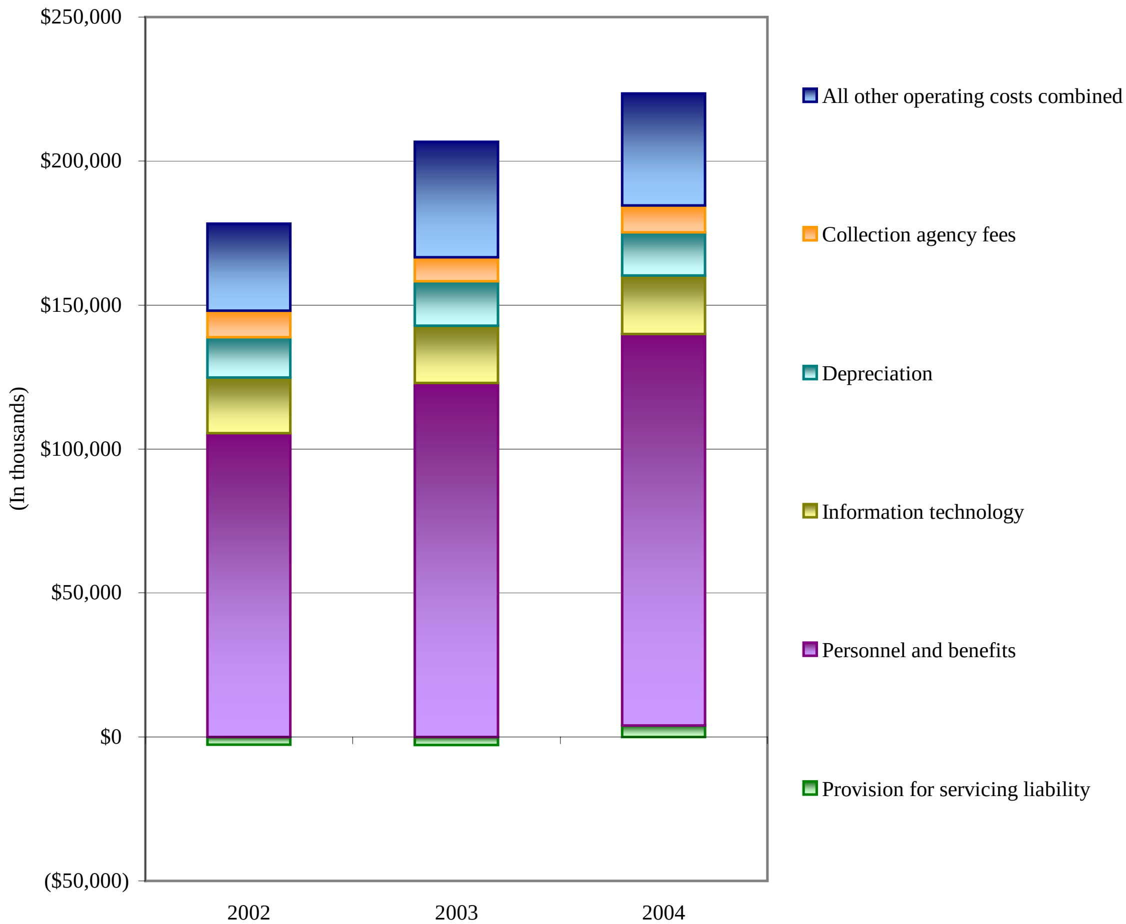
Gains (losses) on student loan sales and securitizations, net

For the year ended June 30, 2004, net losses on student loan sales and securitizations were $702 thousand, compared to net gains of $645 thousand in 2003.

The net loss on student loan sales and securitizations for the year ended June 30, 2004 occurred because we securitized $387.1 million of student loans on December 10, 2003. At the time of the sale, we wrote off unamortized lender origination fees and unamortized premium on purchased loans related to the loans sold.

In a securitization, we sell student loans to a trust that issues bonds backed by the student loans as part of the transaction. A residual interest results from the securitization of student loans, and we estimate based on current conditions that we will receive $9.2 million related to this securitization through the years ending June 30, 2015 with the first receipts of $1.6 million occurring in the year ending 2006. Following GASB guidance, the residual interest is recognized as revenue when the cash flows become available to us. This accounting treatment is different from securitization accounting treatment for businesses following FASB guidance, which involves estimating the net present value of expected future cash flows at the time of the securitization.

Operating Expenses



For the year ended June 30, 2004, operating expenses were $223.5 million, an increase of 9.7% from $203.8 million in 2003. The major reason for the increase is the increase in personnel and health benefit costs. A more detailed discussion of costs follows.

<u>Personnel and Benefits</u>

For the year ended June 30, 2004, personnel and benefit costs were $136.0 million, an increase of 10.7% from $122.9 million in 2003. Included in these costs are health benefits for employees and retirees. For the year ended

June 30, 2004, health benefits for employees and retirees were $22.3 million, an increase of 37.7% from $16.2 million in 2003.

Permanent staff makes up 84.4% of the total personnel and benefits costs. For the year ended June 30, 2004, permanent staff costs were $114.8 million, an increase of 13.0% from $101.6 million in 2003. There were 1,973 permanent staff positions filled at June 30, 2004, an increase of 0.8% from the 1,958 positions filled at June 30, 2003.

For the year ended June 30, 2004, contract staff costs were $5.2 million, a 10.6% increase from $4.7 million in 2003. At June 30, 2004, there were 273 contracted personnel compared to 215 in 2003.

For the year ended June 30, 2004, independent contracting costs were $16.0 million, a 3.6% decrease from $16.6 million in 2003. We generally use independent contractors for specialized services, such as computer programming. Costs vary based upon changes in computer programming initiatives.

Our workforce is unionized. Contractual increases are negotiated and include periodic step increases of 2.2%. While not mandated, our management workers typically receive the same increases as union workers.

Federal Usage Fees

We are required to pay usage fees to the Federal Fund to cover the cost of using assets that were purchased or developed with federal funds. Our agreement with ED is to pay usage fees equal to depreciation expense on the related asset. For the year ended June 30, 2004, the fees amounted to $4.4 million, compared to $6.4 million in 2003. While the related asset lives vary, generally, the assets will be fully depreciated by June 30, 2005 and at that point, there will be minimal usage fees.

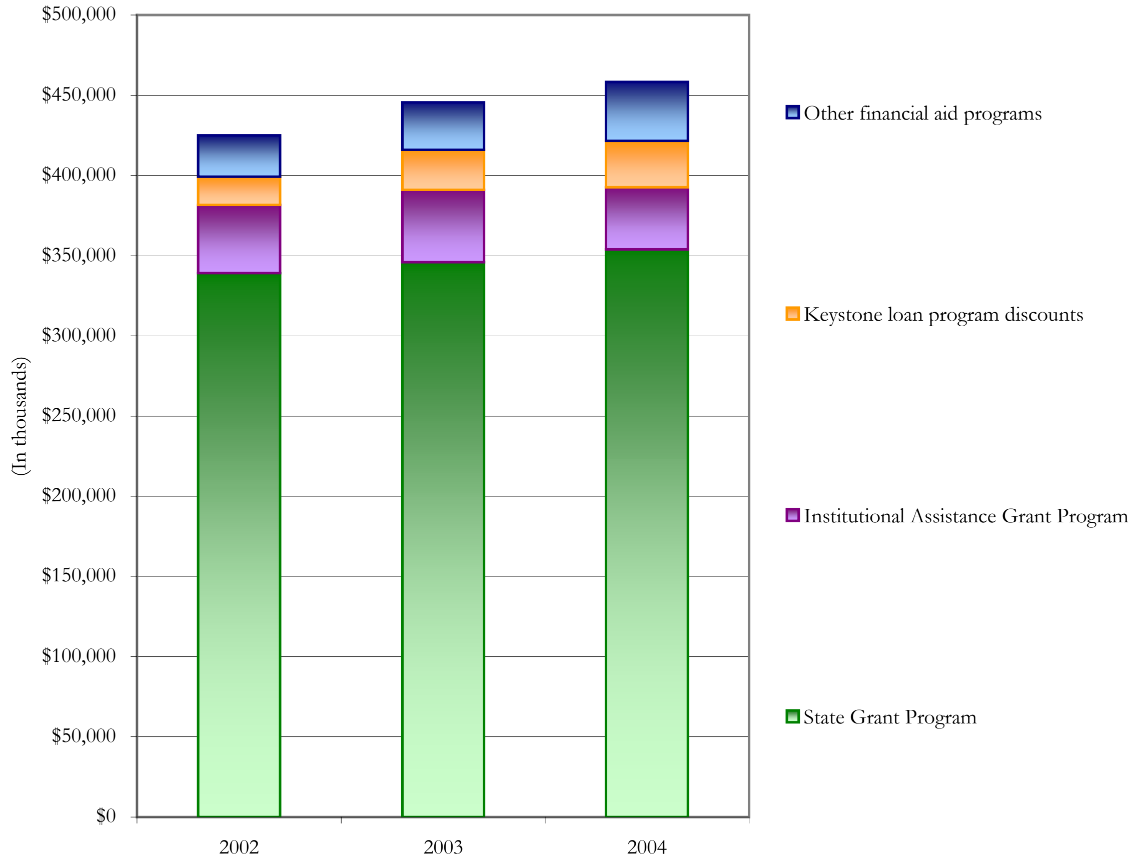
Provision for Servicing Liability

Not meeting ED regulations on servicing can result in losses on the portfolio of loans we own and on the portfolio being serviced for our customers. We make estimates of what the potential losses could be based upon our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions.

Currently, the provision for losses is not a significant expense. However, since the provision could be significant, an analysis of our allowance for servicing losses is presented in the following table:

For the years ended June 30 (in thousands)		2004	2003
Balance at beginning of period	$	**7,035**	11,857
Provision for losses (reduction in allowance)		**3,950**	(2,824)
Charge-offs		**(7,256)**	(1,998)
Balance at end of period	$	**3,729**	7,035
Allowance as a percentage of ending balance of student loans serviced		**0.01%**	0.03%

Financial Aid Activity



For the year ended June 30, 2004, grants and other financial aid were $458.3 million, a 2.9% increase from $445.4 million in 2003. The following table displays financial aid awarded through our various programs.

For the years ended June 30 (in thousands)		**2004**	2003
Self-funded			
Keystone loan program origination fees paid on behalf of borrowers	$	**29,005**	24,955
Armed Forces Loan Forgiveness Program		**7,803**	-
Nursing Loan Forgiveness Program		**23**	-
		36,831	24,955
State and federal funded			
State Grant Program		**354,034**	345,969
Institutional Assistance Grant Program		**38,627**	45,039
Matching Funds Program		**15,384**	14,207
New Economy Technology Scholarship Program		**6,618**	9,206
Other		**6,796**	6,060
		421,459	420,481
	$	**458,290**	445,436

Keystone loan program origination fees paid on behalf of borrowers represent our payment of fees that borrowers typically pay to ED under the federal student loan program. Typically, the borrower is required to pay 3% of the amount borrowed to ED as an up-front origination fee. For loans we originate, we pay all three points. For loans we service for a participating financial institution, we pay one of the three points.

For the year ended June 30, 2004, Commonwealth of Pennsylvania grants were $408.6 million, a 1.2% decrease from $413.6 million in 2003. For the year ended June 30, 2004, federal grants were $10.2 million, an 8.5% increase from $9.4 million in 2003.

During the year ended June 30, 2004, we donated $10.0 million and contributed $1.1 million of services to The Pennsylvania Higher Education Foundation, Inc. The board of directors has authorized an additional $20 million of donations through June 30, 2006 as well as ongoing operational support. The authorization is not an obligation and none of this amount has been accrued.

Financial Position and Liquidity

Most of our net assets are restricted or invested in capital assets. We have unrestricted net assets of $2.4 million at June 30, 2004.

The most substantial restriction on our net assets relates to restrictions for debt service, which amounted to $293.6 million. Of that amount, $288.2 million is related to our student loan bonds and financings, and $104.0 million could be made available. Net assets restricted for financial aid amounted to $61.4 million.

Description of Debt Activity and Significant Capital Assets

Our principal funding need is securing capital to fund student loan originations and purchases. We have a number of sources to raise this capital including access to bond markets and arrangements with banks and the State Treasury. Our ability to raise debt could be limited in the future because under our enabling legislation there is a formula that imposes a debt limit. The limit is $12.0 billion at June 30, 2004. At June 30, 2004, our outstanding debt amounted to $5.2 billion. The following table shows our debt activity.

For the years ended June 30 (in thousands)		2004	2003
Capital market activity			
Proceeds from issuing student loan demand revenue bonds, including $225 million of refunding bonds in 2003	$	**470,000**	1,410,000
Repayment of student loan revenue bonds		**(75,000)**	(150,000)
Repayment of student loan demand revenue bonds		**(25)**	-
Other financings			
Net student loan financing activity		**178,000**	(219,340)
Net capital financing activity		**(2,592)**	(52,321)
Net other financing activity		**(19,903)**	11,196

The following table shows our capital assets, net of accumulated depreciation.

At June 30 (In thousands)		2004	2003
Land	$	**2,946**	2,946
Buildings		**39,973**	39,178
Software development		**19,526**	18,891
Purchased software		**5,977**	4,104
Other, principally information technology equipment		**9,043**	8,961
	$	**77,465**	74,080

The most significant ongoing capital item is software development. Our software development is generally related to customized systems for student financial aid processing that cannot be purchased from vendors. For the year ended June 30, 2004, we capitalized $10.3 million of software development compared to $7.9 million in 2003.

Interest Rate Risk Management

Student loans are generally variable-rate assets, so we generally fund with variable-rate debt.

In the table on the next page, we categorize variable-rate assets and liabilities by reset date and fixed-rate assets and liabilities by their maturity dates. An interest rate gap is the difference between volumes of assets and liabilities maturing or re-pricing during specific future time intervals. The table includes only those assets and liabilities related to our student loan bonds and financings. As well as other assets and liabilities, we have $41.7 million of student loans and $161.5 million of investments not included in the analysis. Because of the significance of variable-rate loans that have a 9.5% floor yield, the amount of those loans is separately disclosed. Due to the current interest rate environment, 9.5% floor loans are classified as having an interest rate sensitivity period of over 5 years. During the year ending June 30, 2005, the 91-day U.S. Treasury Bill rate will have to reach 12.1% for the 9.5% floor loans to have an interest rate sensitivity period of 3 months or less.

In financing our student loan lending and secondary market operations with variable-rate debt, we increase the sensitivity of net interest margin to changing interest rates to the extent that the 9.5% floor loans have a sensitivity period of greater than 3 months.

The following gap analysis reflects rate-sensitive positions at June 30, 2004 and is not necessarily reflective of positions that existed throughout the period.

If a period gap is positive, it means that there are more assets than liabilities re-pricing during the period. If interest rates rise in a period with a positive gap, net interest revenue will increase. Conversely, if interest rates fall in a period with a positive gap, net interest revenue will decrease.

The opposite is true when the period gap is negative. This occurs when more liabilities than assets are re-pricing during the period. If interest rates rise in a period with a negative gap, net interest revenue will decrease. If interest rates fall in a period with a negative gap, net interest revenue will increase.

		Interest rate sensitivity period					
At June 30, 2004 (in thousands)		3 months or less	3 months to 6 months	6 months to 1 year	1 to 2 years	2 to 5 years	Over 5 years
Assets							
Student loans:							
9.5% floor student loans	$	-	-	-	-	-	1,730,906
Other student loans		2,731,054	192,062	157,544	5,815	10,589	9,018
Total student loans		2,731,054	192,062	157,544	5,815	10,589	1,739,924
Investments		277,275	-	-	-	-	26,500
Other assets		75,269	18,596	8,646	6,265	8,056	19,191
Total assets		3,083,598	210,658	166,190	12,080	18,645	1,785,615
Liabilities							
Student loan bonds and financings		4,240,778	728,619	-	-	-	-
Other liabilities		14,109	1,379	2,325	111	1,193	60
Total liabilities		4,254,887	729,998	2,325	111	1,193	60
Net assets							
Restricted for debt service	$	-	-	-	-	-	288,212
Period gap	$	(1,171,289)	(519,340)	163,865	11,969	17,452	1,497,343
Cumulative gap	$	(1,171,289)	(1,690,629)	(1,526,764)	(1,514,795)	(1,497,343)	-
Ratio of interest-sensitive assets to interest-sensitive liabilities and net assets		72.5%	28.9%	7148.0%	10882.9%	1562.9%	619.4%
Ratio of cumulative gap to total assets		-22.2%	-32.0%	-28.9%	-28.7%	-28.4%	0.0%

Because over the course of a year, our debt generally re-prices faster than the assets re-price, decreases in market interest rates will increase net interest revenue while increases in market interest rates will decrease net interest revenue.

The following table shows the simulated impact of a 50 basis point parallel shift downward in interest rates and a 100, 200 and 300 basis point parallel shift upward in interest rates on net interest revenue. A parallel shift means that it would affect both our assets and our debt in the same way at the same time. The analysis was prepared using the levels of assets and liabilities related to our student loan bonds and financings. The impact simulates the effect of rates changing in parallel fashion ratably over the next twelve months.

		Movements in interest rates from June 30, 2004 rates			
		Increase			Decrease
		+100 basis points	+200 basis points	+300 basis points	-50 basis points
Simulated increase (decrease) on net interest revenue over the next twelve months	$	(15,672)	(28,314)	(39,740)	8,032

Federal Student Loan Reserve Fund

Under current law, we are required to manage the Federal Fund so net assets are greater than 0.25% of the original principal balance of outstanding guarantees.

The following table demonstrates that we have managed the Federal Fund to exceed the target required by law.

At June 30 (in thousands)		**2004**	2003
Net assets	$	**68,731**	81,107
Original principal outstanding	$	**24,044,624**	20,475,215
		0.29%	0.40%

For the year ended June 30, 2004, purchases of defaulted loans were $261.9 million, a decrease of 6.1% from $279.0 million in 2003.

Description of Currently Known Facts, Decisions or Conditions Expected to have a Significant Effect on Net Assets or Results of Operations

Changes in short-term interest rates will affect future results of operations. Since June 30, 2004, rates on 91-day U.S. Treasury Bills have increased 0.28% and rates on 3-month commercial paper have increased 0.29%. The potential impact of changes in short-term interest rates was discussed in the interest rate risk management section.

On July 14, 2004, we securitized $388.5 million of student loans for a net gain of $1.8 million. Based on current conditions, we estimate that we will receive residual interest of $20.5 million related to this securitization through the years ending June 30, 2034 with the first receipts of $3.0 million occurring in the year ending 2008.

On August 5, 2004, we issued $171 million of student loan demand revenue bonds. The bonds we issued are variable-rate debt that reset based upon auctions every 35 days and they had an initial rate of 1.48%.

In June 2004, the board of directors authorized the development of a task force to study the effectiveness of the State Grant Program. The task force is charged with, among other things, evaluating the current formula and the board of directors directed that $40 million of our net assets be available to assist in the implementation of the recommendations of the taskforce.

In June 2003, the board of directors authorized the development of programs to deliver an additional $25 million of financial aid. As these programs are developed and implemented, net assets will be used to fund the financial aid. Through June 30, 2004, we have provided $7.8 million of benefits through the Armed Forces Loan Forgiveness Program related to this authorization.

Contacting Us

If you have questions about this report, please contact our Financial Management Division at 1200 N. 7th Street, Harrisburg, PA 17102.

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September 10, 2004

KPMG LLP
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Independent Auditors' Report

The Board of Directors
Pennsylvania Higher Education Assistance Agency:

We have audited the accompanying basic financial statements of the Pennsylvania Higher Education Assistance Agency (PHEAA), a component unit of the Commonwealth of Pennsylvania, as of and for the years ended June 30, 2004 and 2003, as listed in the table of contents. These financial statements are the responsibility of PHEAA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of PHEAA as of June 30, 2004 and 2003, and its changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 2 through 26 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. 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.

KPMG LLP

September 10, 2004

For the years ended June 30 (in thousands)

		2004	2003
Interest revenue			
Student loans	$	**225,883**	199,820
Investments		**13,298**	16,766
Total interest revenue		**239,181**	216,586
Interest expense			
Student loan financings and bonds payable		**66,152**	82,395
Capital and other financings		**9,841**	12,815
Total interest expense		**75,993**	95,210
Net interest revenue		**163,188**	121,376
Provision for loan losses		**(1,758)**	(2,467)
Net interest revenue after provision for loan losses		**161,430**	118,909
Noninterest revenue			
Servicing fees		**74,363**	66,816
Retention of collections on defaulted loans		**55,489**	44,006
Federal fees		**42,846**	34,956
Default aversion fees, net		**8,773**	3,749
Gains (losses) on student loan sales and securitizations, net		**(702)**	645
Other		**205**	189
Total noninterest revenue		**180,974**	150,361
Operating revenues		**342,404**	269,270
Operating expenses			
Personnel		**136,014**	122,931
Information technology related expenses		**20,337**	19,970
Other		**67,137**	60,933
Total operating expenses		**223,488**	203,834
Operating income		**118,916**	65,436
Commonwealth of Pennsylvania grants		**408,555**	413,552
Federal grants		**10,184**	9,354
Grants and other financial aid		**(458,290)**	(445,436)
Contributions to Pennsylvania Higher Education Foundation		**(11,085)**	(10,452)
Net income		**68,280**	32,454
Net assets, beginning of period		**299,491**	267,037
Net assets, end of period	$	**367,771**	299,491

See accompanying notes to financial statements.

At June 30 (in thousands)

		2004	2003
Assets			
Cash and cash equivalents	$	**16,470**	23,120
Restricted cash – due to servicing customers		**68,691**	42,955
Investments		**465,287**	526,698
Loans held for sale		**777,000**	-
Student loans receivable, net		**4,101,701**	4,224,887
Interest income receivable		**96,478**	90,943
Capital assets, net		**77,465**	74,080
Deferred financing costs, net		**26,252**	24,988
Other assets		**27,329**	22,851
Federal Student Loan Reserve Fund assets held for the U.S. Department of Education		**105,328**	114,864
Total assets		**5,762,001**	5,145,386
Liabilities			
Accounts payable and accrued expenses		**133,275**	124,224
Notes and bonds payable, net		**5,155,627**	4,606,807
Amounts related to the Federal Student Loan Reserve Fund		**105,328**	114,864
Total liabilities		**5,394,230**	4,845,895
Net assets			
Invested in capital assets, net of related debt		**3,776**	(2,160)
Restricted for debt service		**293,621**	231,844
Restricted for financial aid		**61,434**	57,309
Restricted for default aversion activities		**6,522**	8,149
Unrestricted		**2,418**	4,349
Total net assets	$	**367,771**	299,491

See accompanying notes to financial statements.

For the years ended June 30 (in thousands)

		2004	2003
Cash flows from operating activities			
Interest received on student loans	$	**236,327**	201,775
Principal received on student loans		**553,198**	511,531
Student loan originations		**(705,334)**	(616,003)
Student loan purchases		**(948,604)**	(1,054,887)
Student loan sales and securitizations		**428,003**	143,948
Interest received on investments		**13,782**	16,871
Interest paid on student loan financings and bonds payable		**(69,058)**	(80,457)
Interest paid on capital and other financings		**(9,465)**	(13,025)
Servicing fees		**74,213**	70,355
Retention of collections on defaulted loans		**55,489**	44,006
Federal fees		**38,084**	31,555
Default aversion fees		**8,955**	7,383
Other		**205**	189
Payment of operating expenses		**(220,407)**	(174,740)
Net cash used for operations		**(544,612)**	(911,499)
Cash flows from noncapital financing activities			
Proceeds from issuance of noncapital debt		**930,474**	1,752,168
Principal paid on noncapital debt		**(379,928)**	(704,279)
Issuance costs		**(2,359)**	(7,333)
Commonwealth of Pennsylvania grants		**408,555**	413,552
Federal grants		**10,184**	9,354
Grants and financial aid		**(458,290)**	(445,436)
Contributions to Pennsylvania Higher Education Foundation		**(11,085)**	(10,452)
Net cash provided by noncapital financing activities		**497,551**	1,007,574
Cash flows from capital and related financing activities			
Proceeds from issuance of capital debt		**1,116**	-
Principal paid on capital debt and obligation under capital lease		**(3,708)**	(52,321)
Purchases of capital assets and development of software, net of disposals		**(18,408)**	(13,374)
Net cash used for capital and related financing activities		**(21,000)**	(65,695)
Cash flows from investing activities			
Proceeds from sales and maturities of investments		**11,582,351**	15,200,608
Purchases of investments		**(11,520,940)**	(15,216,748)
Net cash provided by (used for) investing activities		**61,411**	(16,140)
Net change in cash and cash equivalents		**(6,650)**	14,240
Cash and cash equivalents, beginning of period		**23,120**	8,880
Cash and cash equivalents, end of period	$	**16,470**	23,120

(continued)

For the years ended June 30 (in thousands)

		2004	2003
Reconciliation of operating income to net cash used for operating activities			
Operating income	$	**118,916**	65,436
Adjustments to reconcile operating income to net cash used for operating activities:			
Depreciation and amortization		**15,023**	15,370
Amortization of premium on loan purchases		**18,221**	13,956
Amortization of loan origination costs		**2,669**	1,631
Amortization of deferred financing costs		**1,095**	2,759
Amortization of deferred amount on refundings of student loan revenue bonds		**799**	641
Accretion discount on capital and other financings		**67**	81
Changes in assets and liabilities:			
Increase in interest income receivable		**(5,535)**	(9,429)
Increase in loans held for sale		**(777,000)**	-
Decrease (increase) in student loans receivable		**102,296**	(1,017,687)
Increase in other assets		**(4,478)**	(967)
Increase (decrease) in accounts payable and accrued expenses		**(16,685)**	16,710
Total adjustments		**(663,528)**	(976,935)
Net cash used for operating activities	$	**(544,612)**	(911,499)

See accompanying notes to financial statements.

Note 1 – About PHEAA

Organization

PHEAA, doing business as AES, is a public corporation and government instrumentality created by the Pennsylvania General Assembly on August 7, 1963. Our mission is to improve higher education opportunities for Pennsylvanians.

We are a discretely presented component unit of the Commonwealth of Pennsylvania. That means that our financial information is included in the financial statements of the Commonwealth but we are not considered part of the primary government.

Blended Component Unit

We formed PHEAA Student Loan Foundation, Inc. on August 6, 2002. The foundation is exempt from federal income tax under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(3). Its charitable purpose is to carry out student loan securitization transactions for our benefit. The foundation is a blended component unit because we appoint a majority of the foundation's board of directors, can impose our will on the foundation, and it provides services entirely to us. As a blended component unit, its transactions are consolidated in our financial statements.

Related Organizations

The Pennsylvania Higher Education Foundation, Inc.

We supported the formation of The Pennsylvania Higher Education Foundation, Inc. ("PHEF"), which is tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Its charitable purposes include, but are not limited to, activities intended to improve or enhance postsecondary education opportunities for students in Pennsylvania and elsewhere. Members of our Executive Committee appoint a majority of the board members of PHEF, but we cannot impose our will on it, and there is no financial burden or benefit associated with it. As a related organization, its transactions are not included in our financial statements.

PHEF's financial statements are available on its website – www.higheredfoundation.org. Condensed financial information for PHEF as of and for its fiscal years that ended May 31 follows.

For the years ended May 31 (in thousands)		**2004**	2003
Contributions	$	**11,011**	13,475
Income on investments		**2,368**	595
Expenses, including $5.4 million of grants in 2004		**(6,322)**	(350)
Increase in net assets		**7,057**	13,720
Net assets at beginning of year		**26,767**	13,047
Net assets at end of year	$	**33,824**	26,767

At May 31 (in thousands)		2004	2003
Investments	$	**35,103**	26,645
Office furnishings and equipment, net of accumulated depreciation		**130**	118
Amounts payable to specific organizations as designated by donors		**(1,413)**	-
Other assets, net of liabilities		**4**	4
Net assets	$	**33,824**	26,767

We made a cash donation of $10 million to PHEF in both June 2003 and June 2004. We are also authorized to provide operational support to PHEF, which cost $1.1 million during the year ended June 30, 2004 and $452 thousand in 2003.

Our board of directors has authorized an additional $20 million of transfers through June 30, 2006, but the authorization is non-binding and has not been accrued in our financial statements.

PHEF created the Nursing Education Grant Program to provide a new source of financial support to schools. The intent of the program is to encourage additional students to pursue nursing as an academic and professional choice. For the 2004-05 program year, PHEF has received 110 applications and grant proposals that, if approved by the board of directors of PHEF, will result in grants of $8.7 million. PHEF expects that these grants, if approved, will be paid by its next year-end of May 31, 2005.

The Higher Education Foundation, Inc.

We also supported the formation of The Higher Education Foundation, Inc. ("HEF") and it is also tax-exempt under Section 501(c)(3) of the Internal Revenue Code. Its charitable purpose is exclusively for the benefit of PHEF and the directors of PHEF are directors of HEF. HEF was formed to assist with fundraising and program administration particularly for projects that may extend beyond Pennsylvania. As with PHEF, we cannot impose our will on HEF, there is no financial burden or benefit associated with it, and its financial transactions are not included in our financial statements. PHEF prepares consolidated financial statements that include transactions for HEF.

Note 2 – Summary of Significant Accounting Policies

Because we are financed and operated in a manner similar to private business enterprises, we are accounted for as an enterprise fund and follow the economic resources measurement focus and accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place. While private business enterprises follow the accounting guidance issued by the Financial Accounting Standards Board ("FASB"), we follow the guidance issued by the Governmental Accounting Standards Board ("GASB"). As encouraged by the GASB we have elected not to follow FASB pronouncements issued after November 30, 1989 to be consistent with the accounting practices of the Commonwealth.

Student Loans

Student loans are reported on the statement of net assets at their unpaid principal balances. Costs related to loan originations and premiums related to loan purchases are deferred and recognized over the life of the loan, after giving effect to estimated prepayments, as an adjustment of yield. The deferred amount is reported as part of the principal balance of student loans. We also reduce the reported value of student loans to reflect inherent loan losses.

Student loan income is recognized as earned including adjustments for the amortization of costs of loan originations and purchases.

Allowances for potential losses on our student loans can result from deficient servicing, risk-sharing on defaults and on uninsured loans. These allowances are based upon our ongoing evaluation of the loan portfolios, past and anticipated loss experience and the amount and quality of the loans. The allowances are maintained at a level that we believe is adequate to absorb inherent estimated incurred losses, but our evaluation is inherently subjective and the required allowances may significantly change in the future.

Expenses related to risk sharing on defaults are reported in the provision for loan losses, and expenses that relate to servicing deficiencies are included in operating expenses.

Cash Equivalents

We consider all liquid debt instruments with original maturities of one year or less to be cash equivalents.

Investments

Investments in nonparticipating investment contracts and are reported at amortized cost. Other investments are reported at fair values based upon information provided by external investment managers.

Capital Assets

Capital assets are reported at cost net of depreciation and estimated impairment, if any. Assets held under capital leases are reported at the present value of minimum lease payments net of amortization. Depreciation is calculated on the straight-line method over the estimated useful life of the asset. Assets held under capital leases and leasehold improvements are amortized on the straight-line method over the shorter of the lease term or the estimated useful life of the asset.

Software development is reported at cost net of amortization. Amortization is calculated on the straight-line method over the estimated useful life of the software developed.

We capitalize assets that cost $10,000 or more; amounts under that threshold are expensed. The following estimated useful lives are used for significant asset categories:

▪ Buildings	25 – 40 years
▪ Furniture, furnishings and equipment	5 – 10 years
▪ Software development	3 – 5 years

Deferred Financing Costs

Deferred financing costs consist of underwriting and other costs of issuing financings. The costs are amortized over the term of the financing using methods that approximate the effective interest method and are included in interest expense.

Compensated Absences

Employees earn annual leave based upon years of service and may carry forward up to 45 days of unused leave at the end of each calendar year. Employees are paid for accumulated annual leave at termination or retirement. Employees earn sick leave and may carry forward up to 300 days of unused leave at the end of each calendar year. Employees are paid a portion of accumulated sick leave at retirement based upon a formula. Estimated amounts payable upon retirement or termination under these arrangements are included in accrued expenses on the statement of net assets.

Operating Revenues and Expenses

Operating revenues include net interest revenue earned on student loans and investments and fees earned from providing services. Operating expenses include the costs of providing services and operating all programs. Grants received and grants and financial aid disbursed are not reported as components of operating income.

Revenue Recognition

Servicing fees are recognized as the contractual services are provided and unbilled amounts are recorded as accounts receivable. For federal fees, loan processing and issuance fees related to our guaranty function are recognized as the guaranteed loans are disbursed; portfolio maintenance fees are recognized throughout the year at rates established by law. Retention of collections on defaulted loans is recognized as earned when cash is collected on defaulted loans.

We receive default aversion fees amounting to 1% of the principal and interest of a loan when the lender submits a default preclaim. These fees are transferred from the Federal Fund. If the loan later defaults, we must return to the Federal Fund 1% of the principal and interest of the loan at the time of the default. Revenue recognized from default aversion fees is net of the amount we estimate will have to be returned to the Federal Fund. For the Federal Fund the entire default aversion fee is recognized as an expense when the expense is paid. As we return amounts when loans default, the amount returned offsets the expense.

Securitization

In a securitization, we sell student loans to a trust that issues bonds backed by the student loans as part of the transaction. The securitized loans, bonds, and related income and expenses are not reported in our financial statements. A residual interest results from a securitization transaction. Following GASB guidance, the residual interest is recognized as revenue when the cash flows become available to us. This accounting treatment is different from securitization accounting treatment for businesses following FASB guidance, which involves estimating the net present value of expected future cash flows at the time of the securitization.

Advertising

We expense the costs of advertising as costs are incurred. Most advertising expenses are related to making sure Pennsylvanians are aware of postsecondary education opportunities and default prevention initiatives. Advertising expenses were $5.7 million in 2004 and $3.4 million in 2003.

Commonwealth of Pennsylvania and Federal Grant Revenues

Commonwealth and federal grants are nonexchange transactions. We use the receipts as a source of funds to disburse grants and financial aid. Our agreements contain restrictions requiring us to spend the money in accordance with the legislation or grant agreement, but generally do not refer to specific time requirements. Accordingly, the entire amount received is recognized as revenue when we receive it.

Use of Estimates

To prepare financial statements in conformity with accounting principles that are generally accepted in the United States of America we must make estimates and assumptions that influence the reported assets, liabilities, revenues, and expenses. In the future actual results could be different from our estimates.

Note 3 – New Accounting Pronouncements

In March 2003, the GASB issued GASB Statement No. 40, *Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3*. This statement must be adopted for periods beginning after June 15, 2004. We have analyzed the statement and we do not believe this statement will significantly change our disclosures related to cash and investments.

In June 2004, the GASB issued GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This statement must be adopted for periods beginning after December 15, 2006. We anticipate that this statement will change expense recognition and disclosure related to healthcare benefits provided for retirees; however, we have not completed our analysis of the statement, which must be adopted for the year ending June 30, 2008.

Note 4 – Federal Student Loan Reserve Fund and Assets Held for the U.S. Department of Education

As a part of our guaranty operations, we manage the Federal Fund for ED. The Federal Fund is used to pay claims on defaulted loans and belongs to the federal government. On the statements of net assets, we report the total assets of the Federal Fund under the caption “Federal Student Loan Reserve Fund assets held for the U.S. Department of Education.” We also report the same amount as a liability on the statements of net assets. Because the Federal Fund has both assets and liabilities, we use a net asset approach in the following tables to report activity in the fund.

The following table shows the changes in net assets held by us for ED in the Federal Fund.

For the years ended June 30 (in thousands)		2004	2003
Additions			
Reinsurance from the U.S. Department of Education	$	**254,616**	272,055
Collections on defaulted loans		**184,239**	151,359
Net appreciation in fair value of investments		**2,669**	2,476
Student loan insurance premiums		**3,107**	4,240
Usage fees		**4,408**	6,657
Other		**78**	-
Total additions		**449,117**	436,787
Deductions			
Purchases of defaulted loans from lenders		**261,946**	278,996
Reimbursement to U.S. Department of Education for federal share of defaulted loans collections		**126,015**	105,713
Reimbursement to us for our retention of defaulted loans collections		**55,489**	44,006
Default aversion fees, net		**9,377**	7,004
Transfers to PHEAA for portfolio maintenance fee not paid by U.S. Department of Education		**4,257**	2,722
Other		**4,409**	6,762
Total deductions		**461,493**	445,203
Net decrease		**(12,376)**	(8,416)
Net assets, beginning of period		**81,107**	89,523
Net assets, end of period	$	**68,731**	81,107

The following table shows the detail of the net assets held by us for ED in the Federal Fund.

At June 30 (in thousands)		2004	2003
Assets			
Cash and cash equivalents	$	**17,885**	25,756
Receivable from the U.S. Department of Education		**17,348**	17,232
Other receivables		**198**	215
Interest income receivable		**155**	1,534
Investments		**65,428**	61,404
Capital assets, net		**4,314**	8,723
Total assets		**105,328**	114,864
Liabilities			
Default claims payable to lenders		**14,501**	8,554
Payable to U.S. Department of Education		**17,364**	17,364
Deferred student loan insurance premiums		**4,732**	7,839
Total liabilities		**36,597**	33,757
Net assets	$	**68,731**	81,107

The Higher Education Amendments of 1998 contain a provision for a recall of funds totaling $250 million nationwide. $85 million of the recall occurred in the federal fiscal year ended September 30, 2002, $82.5 million is to occur in the year ending September 30, 2006 and $82.5 million is to occur in the year ending September 30, 2007. On July 11, 2002, ED informed us that the Federal Fund's share of the recall was $26.3 million, of which $8.9 million was due and paid by September 1, 2002. The entire $26.3 million was recorded as a deduction from net assets during the year ended June 30, 2002. $17.4 million remains as an amount payable to the U.S. Department of Education at June 30, 2004 for the recalls due in 2006 and 2007.

Under the Higher Education Amendments of 1998, we are to act as a fiduciary in managing the assets of the Federal Fund.

Note 5 – Cash and Investments

The following table shows cash deposits managed by us.

At June 30 (in thousands)		2004	2003
Cash and cash equivalents	$	**16,470**	23,120
Cash in the Federal Fund		**17,885**	25,756
Carrying value	$	**34,355**	48,876
Bank balance	$	**12,054**	31,659
Less insured balance		**(100)**	(100)
Uninsured balance	$	**11,954**	31,559

At June 30, 2004, $16.5 million of our cash was restricted under bond indentures and financing arrangements. At June 30, 2003, that amount was $9.0 million.

The insured balance was covered by federal depository insurance and the uninsured balance was collateralized following an agreement to pledge assets on a pooled basis to secure public deposits in Pennsylvania. All collateral on deposits is held by the participating financial institution's trust department and is not in our name.

Generally, our investments are limited by the board of directors to U.S. Treasury Bills and notes, federal agency securities, repurchase agreements collateralized by U.S. Treasury obligations, certificates of deposit, high-grade commercial paper, student and/or parent loans, notes issued by the Student Loan Marketing Association, and other investments approved by the board of directors from time to time. We also invest in an investment pool, which is a short-term investment portfolio maintained by the Commonwealth of Pennsylvania Treasury Department's Bureau of Cash Management and Investments for the benefit of all Commonwealth funds. Our investments under certain debt and bond agreements are also further described in those agreements.

GASB requires investments to be categorized to give an indication of the level of risk assumed by us at year-end. The categories are as follows:

- Category 1 includes investments that are insured or registered or for which we, or an agent in our name, hold the securities.
- Category 2 includes uninsured and unregistered investments for which the broker or dealer's trust department or agent holds the securities in our name.
- Category 3 includes uninsured and unregistered investments that are either uncollateralized or for which the securities are held by the broker or dealer, or by its trust department or agent but not in our name.

At June 30, 2004, none of our investments meets the above definitions, and all are uncategorized.

The term investments, as used above, includes securities underlying repurchase agreements and investment securities.

The following table shows our investments at June 30, 2004.

(In thousands)		Carrying Value
Invested amounts not susceptible to credit risk categorization:		
Money market funds	$	133,693
State Treasury investment pool		42,760
Trinity Plus guaranteed investment agreement		169,020
Guaranteed investment contract – MBIA		72,418
Guaranteed investment contract – Trinity Plus Funding Company		26,700
Guaranteed investment contract – CDC Funding Corporation		8,000
Bayerische investment agreement		7,643
Guaranteed investment contract – AIG Matched Funding Corporation		5,053
	$	465,287

$303.8 million of our investments are restricted under bond indentures and financing arrangements. $361.3 million of the investments mature within one year.

The following table shows investments in the Federal Fund at June 30, 2004.

(In thousands)		Carrying Value
Invested amounts not susceptible to credit risk categorization:		
State Treasury investment pool	$	65,428

The following table shows our investments at June 30, 2003.

(In thousands)		Category 3		Carrying Value
American Express Credit Company commercial paper	$	50,000		50,000
Household Finance Corporation commercial paper		50,000		50,000
General Electric Capital Corporation commercial paper		48,000		48,000
	$	148,000		148,000
Invested amounts not susceptible to credit risk categorization:				
Money market funds				111,975
State Treasury investment pool				47,360
PA Treasury Invest				78,769
Guaranteed investment contract – MBIA				73,951
Guaranteed investment contract – Trinity Plus Funding Company				32,700
Bayerische investment agreement				15,643
Guaranteed investment contract – CDC Funding Corporation				8,900
Guaranteed investment contract – AIG Matched Funding Corporation				5,053
Trinity Plus investment agreement				4,347
			$	526,698

At June 30, 2003, $384.3 million of our investments were restricted under bond indentures and financing arrangements, and $399.4 million matured within one year.

The following table shows investments in the Federal Fund at June 30, 2003.

(In thousands)		Carrying Value
Invested amounts not susceptible to credit risk categorization:		
State Treasury investment pool	$	61,404

Investments carry interest rates from 0.67% to 5.74% at June 30, 2004 and rates from 0.72% to 5.74% at June 30, 2003.

Note 6 – Student Loans Receivable

The following table shows our student loan holdings.

At June 30 (in thousands)		2004	2003
FFELP:			
Stafford	$	**3,038,728**	2,659,259
PLUS		**148,546**	171,358
Supplemental Loans for Students		**6,801**	8,742
Consolidation		**1,393,467**	1,078,501
		4,587,542	3,917,860
HEAL		**191,144**	220,737
Privately insured loans		**30,330**	21,686
Uninsured loans		**10,335**	10,682
Unamortized loan origination costs		**9,663**	7,600
Unamortized premium on loan purchases		**54,872**	52,057
		4,883,886	4,230,622
Allowance for loan losses		**(5,185)**	(5,735)
		4,878,701	4,224,887
Less loans held for sale		**(777,000)**	-
	$	**4,101,701**	4,224,887

We estimate that payments on student loans will approximate $600 million during the next year.

On July 14, 2004, we securitized $388.5 million of student loans for a net gain of $1.8 million. We expect to securitize an additional $388.5 million of student loans and expect the transaction to result in a net gain during the next year. Loans that we securitized and that we expect to securitize in the next year are classified as loans held for sale.

Under FFELP, 98% of principal and interest on student loans originated after October 1, 1993 is guaranteed. Loans originated before October 1, 1993 are 100% guaranteed. FFELP loans are guaranteed through the Federal Fund and reinsured by ED. HEAL loans are guaranteed by the Secretary of the U.S. Department of Health and Human Services. The guarantees for both FFELP and HEAL loans are subject to regulatory requirements related to loan servicing.

The provision for loan losses reported in the table below represents our estimate of the costs related to the 2% risk sharing on FFELP loans and losses related to servicing of loans we own. Losses related to servicing are reported as a component of operating expenses. In making our estimates, we consider the trend in default rates in our portfolio and changes in economic conditions and our continuing evaluation of the loan portfolio, past and anticipated loss experience, current operating information, and changes in economic conditions. We believe the provision for loan losses is adequate to cover inherent losses in the student loan portfolio.

For the years ended June 30 (in thousands)		**2004**	2003
Balance at beginning of period	$	**5,735**	4,260
Provision for losses (reduction in allowance)		**5,705**	1,896
Charge-offs		**(6,255)**	(421)
Balance at end of period	$	**5,185**	5,735

At June 30, 2004, we had commitments to purchase approximately $800 million of student loans.

Note 7 – Capital Assets

Capital asset activity for the year ended June 30, 2004 was as follows.

(In thousands)		Beginning Balance	Additions	Retirements	Ending Balance
Land	$	2,946	-	-	2,946
Buildings		63,097	2,263	-	65,360
Software development		54,890	10,265	(2,127)	63,028
Purchased software		8,974	3,755	(40)	12,689
Other, principally information technology equipment		25,622	4,329	(4,071)	25,880
		155,529	20,612	(6,238)	169,903
Less accumulated depreciation for:					
Buildings		(23,919)	(1,470)	2	(25,387)
Software development		(35,999)	(8,208)	705	(43,502)
Purchased software		(4,870)	(1,844)	2	(6,712)
Other, principally information technology equipment		(16,661)	(3,501)	3,325	(16,837)
		(81,449)	(15,023)	4,034	(92,438)
	$	74,080	5,589	(2,204)	77,465

Capital asset activity for the year ended June 30, 2003 was as follows.

(In thousands)		Beginning Balance	Additions	Retirements	Ending Balance
Land	$	2,946	-	-	2,946
Buildings		62,720	377	-	63,097
Software development		46,974	7,916	-	54,890
Purchased software		7,729	1,665	(420)	8,974
Other, principally information technology equipment		22,872	3,726	(976)	25,622
		143,241	13,684	(1,396)	155,529
Less accumulated depreciation for:					
Buildings		(21,975)	(1,944)	-	(23,919)
Software development		(27,827)	(8,172)	-	(35,999)
Purchased software		(3,658)	(1,505)	293	(4,870)
Other, principally information technology equipment		(13,705)	(3,749)	793	(16,661)
		(67,165)	(15,370)	1,086	(81,449)
	$	76,076	(1,686)	(310)	74,080

Note 8 – Notes and Bonds Payable and Other Financings

Activity for notes and bonds payable and other financings for the year ended June 30, 2004 was as follows.

(In thousands)		Beginning Balance	Additions	Reductions	Remarketing	Ending Balance	Amounts Due within One Year
Student loan financings, due 2005-2008 at weighted-average rates of 1.60% at June 30, 2004 and 1.65% at June 30, 2003	$	550,619	453,000	(275,000)	-	728,619	141,709
Student loan demand revenue bonds:							
Student loan demand revenue bonds, due 2017-2044, at weighted-average rates of 1.31% at June 30, 2004 and 1.14% at June 30, 2003		3,471,000	470,000	(25)	312,925	4,253,900	-
Deferred amount on current refundings of student loan demand revenue bonds		-	(2,526)	799	(11,395)	(13,122)	-
		3,471,000	467,474	774	301,530	4,240,778	-
Student loan revenue bonds:							
Student loan revenue bonds at weighted-average rates of 3.30% at June 30, 2003		387,925	-	(75,000)	(312,925)	-	-
Deferred amount on current refundings of student loan revenue bonds		(11,395)	-	-	11,395	-	-
		376,530	-	(75,000)	(301,530)	-	-
Capital financings:							
Capital financings, due 2005-2011, at weighted-average rates of 6.09% at June 30, 2004 and 6.23% at June 30, 2003		76,592	1,116	(3,708)	-	74,000	6,673
Unamortized discount on capital acquisition bonds		(352)	-	41	-	(311)	-
		76,240	1,116	(3,667)	-	73,689	6,673
Other financings:							
Term financings, due 2005-2031, at weighted-average rates of 5.17% at June 30, 2004 and 5.22% at June 30, 2003		87,022	-	(5,903)	-	81,119	9,261
Unamortized discount on capital acquisition refunding bonds		(604)	-	26	-	(578)	-
Lines of credit, due on demand, at weighted-average rates of 3.01% at June 30, 2004 and 3.47% at June 30, 2003		46,000	10,000	(24,000)	-	32,000	32,000
		132,418	10,000	(29,877)	-	112,541	41,261
	$	4,606,807	931,590	(382,770)	-	5,155,627	189,643

The note and bond indentures among other things require us to comply with various covenants including minimum parity levels as defined, student loan and investment yields, and program expenses.

Student loans and investments collateralize all student loan financings, student loan demand revenue bonds, and student loan revenue bonds. At June 30, 2004, $4.9 billion of student loan principal and related interest receivable and $303.8 million of investments and related interest receivable collateralized the $5.0 billion of notes and bonds payable.

The student loan demand bonds are subject to purchase, at par plus accrued interest, by us on demand of the holder upon seven days prior irrevocable written notice. Under the irrevocable letters of credit, the trustee is entitled to draw an amount sufficient to pay the purchase price of bonds delivered to it. The letters of credit are valid from 2004 through 2010, and we are required to pay annual commitment fees ranging from 18 to 33 basis points on the stated amount of the letter of credit coverage. At June 30, 2004, total letter of credit coverage was $1.5 billion.

Capital financings are collateralized with capital assets. Amounts due under the other lines of credit are secured by accounts receivable, student loans, or are unsecured.

At June 30, 2004, we had $139 million of available credit under student loan financing arrangements, and $23 million was available under other lines of credit.

The following tables display the debt service requirements based upon the stated maturities for demand bonds and current interest rates for variable-rate debt.

(In thousands)		Student Loan Bonds and Financings		Capital and Other Financings	
Year of Maturity		Principal	Interest	Principal	Interest
2005	$	141,709	65,496	47,934	8,030
2006		-	55,819	3,570	7,571
2007		586,910	55,819	3,235	7,289
2008		-	55,819	3,385	7,116
2009		-	55,819	3,330	6,956
2010-2014		-	279,094	74,735	20,269
2015-2019		538,900	270,503	9,380	12,566
2020-2024		445,000	245,433	16,160	9,202
2025-2029		600,000	215,335	20,625	4,834
2030-2034		150,000	185,386	4,765	451
2035-2039		470,000	173,568	-	-
2040-2044		2,050,000	79,947	-	-
	$	4,982,519	1,738,038	187,119	84,284

$5.0 billion of the student loan bonds and financings are variable-rate debt. $1.4 billion of the variable-rate debt resets based upon auctions every 7 days. $2.2 billion resets based upon auctions every 28 days. $620 million resets based upon auctions every 35 days. $586.9 million is indexed to 91-day U.S. Treasury Bills and the remaining $141.7 million is indexed to the 3-month LIBOR.

On July 1, 2003, $312.9 million student loan revenue bonds at a weighted average rate of 2.64% fixed were changed to variable rate bonds with a weighted average rate of 1.05% for the year ended June 30, 2004. For the year ended June 30, 2004, interest payments were reduced by $5.0 million because of the remarketing.

During 2003, we issued $225.0 million in student loan demand revenue bonds to refund $225.0 million of outstanding student loan revenue bonds. $150.0 million of bonds were refunded on July 25, 2002, decreasing the effective rate from 6.22% to variable-rate bonds with a weighted-average rate of 1.28% for the year ended June 30, 2003. An additional $75.0 million was refunded on July 1, 2003 decreasing the effective rate from 6.05% to variable-rate bonds with a weighted-average rate of 1.05% for the year ended June 30, 2004. For the year ended June 30, 2004, interest payments were reduced by $3.7 million because of the refundings. The refundings resulted in a difference between the reacquisition price and the net carrying amount of the old debt of $2.5 million in 2004 and $4.0 million in 2003. This difference, reported in the accompanying statements of net assets as a deduction from bonds payable, is being charged to student loan financings and bonds payable interest expense ratably over the life of the student loan revenue bonds.

At June 30, 2004, we had not yet issued $2.3 billion of debt that the board of directors has authorized. On August 5, 2004, we issued $171 million of student loan demand revenue bonds. The bonds we issued are variable-rate debt that reset based upon auctions every 35 days and they had an initial rate of 1.48%.

Notes and bonds payable, as well as all other debt, are limited obligations. We have no taxing power, and the Commonwealth is not obligated to pay the principal, redemption price, if any, or interest on any of our debt.

Activity for notes and bonds payable and other financings for the year ended June 30, 2003 was as follows.

(In thousands)		Beginning Balance	Additions	Reductions	Ending Balance
Student loan financings	$	769,959	330,135	(549,475)	550,619
Student loan demand revenue bonds		2,061,000	1,410,000	-	3,471,000
Student loan revenue bonds:					
Student loan revenue bonds		537,925	-	(150,000)	387,925
Deferred amount on current refundings of student loan revenue bonds		(8,069)	(3,967)	641	(11,395)
		529,856	(3,967)	(149,359)	376,530
Capital financings:					
Capital financings		79,283	-	(2,691)	76,592
Unamortized discount on capital acquisition bonds		(407)	-	55	(352)
		78,876	-	(2,636)	76,240
Other financings:					
Term financings		91,826	-	(4,804)	87,022
Unamortized discount on capital acquisition refunding bonds		(630)	-	26	(604)
Lines of credit		30,000	16,000	-	46,000
		121,196	16,000	(4,778)	132,418
Obligation under capital lease		49,630	-	(49,630)	-
	$	3,610,517	1,752,168	(755,878)	4,606,807

Note 9 – Leases

We lease information technology and other equipment under operating leases expiring during the next three years. In most cases, we expect the leases to be renewed or replaced by other leases in the normal course of business. Total expense for all operating leases was $4.2 million in 2004 and $5.3 million in 2003.

Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) at June 30, 2004 are:

Year ending June 30 (in thousands)		
2005	$	3,080
2006		2,361
2007		1,500
2008		648
Total minimum lease payments	$	7,589

Note 10 – Retirement and Other Postemployment Benefits

Retirement Plan

Plan Description

We contribute to the Commonwealth of Pennsylvania State Employes' Retirement System ("SERS"), a cost-sharing multiple-employer defined benefit pension plan established under the provisions of Public Law 858, No. 331. SERS provides retirement, death, and disability benefits. Article II of the Commonwealth of Pennsylvania's Constitution assigns the authority to establish and amend the benefit provisions of the plan to the General Assembly.

As a blended component unit of the Commonwealth, SERS issues an audited financial report that includes financial statements and required supplementary information. Audited financial statements for all Commonwealth component units are available from the individual organizations. Interested parties should write the Commonwealth of Pennsylvania, State Employes' Retirement System, 30 North Third Street, P.O. Box 1147, Harrisburg, Pennsylvania 17108-1147 to obtain the report.

Funding Policy

Members are required to contribute to the plan. For most members the contribution rate is 6.25% of annual covered salary. As an employer, we are required to contribute at an actuarially determined rate. During the year ended June 30, 2004, the required employer contribution rates were 0.41% or 0.50%, depending upon the membership classification of each employee. Beginning July 1, 2004, our contribution rates will be 1.15% or 1.43%. The contribution requirement of members is established by law and may be amended by the General Assembly. The contribution requirement for us is established by the board of directors of SERS. Our contributions were $458 thousand for the year ended June 30, 2004; $24 thousand for the year ended June 30, 2003; and $20 thousand for the year ended June 30, 2002. These contributions were equal to the required contributions for each year.

Postemployment Benefits

The Commonwealth also provides certain health care benefits for retired employees meeting specified length-of-service and age requirements. These benefits are provided through negotiated union contracts and administrative policy. These benefits are administered by insurance companies whose premiums are based on the benefits paid during the fiscal year. The Commonwealth recognizes the cost of providing these benefits as paid, and charges the Agency for a proportionate share of such costs. These costs amounted to $8.4 million for the year ended June 30, 2004; $6.9 million for the year ended June 30, 2003; and $6.3 million for the year ended June 30, 2002.

Note 11 – Servicing Fees

We have contracts with customers to provide servicing of student loans as well as information technology services. At June 30, 2004, we were servicing approximately $20.5 billion of loans for customers. Customers using our computer services serviced an additional $9.4 billion of loans. Other FFELP guarantors were managing $2.0 billion of guarantees using our computer services.

Our servicing agreements, some of which expire in 2005, have contractual terms at inception ranging from three years to life of loan. Under our servicing agreements, we generally agree to reimburse customers for any claims, losses, liabilities, or expenses that arise out of or relate to our acts or omissions with respect to services provided under such agreements. A provision for estimated claims under the agreements is recorded as a component of operating expenses in the financial statements.

Five loan-servicing customers provided $36.9 million of servicing fees for the year ended June 30, 2004. No other individual customer provided servicing revenues more than 5% of total servicing fees.

Note 12 – Segment Information

We generally finance student loan portfolios by issuing bonds and other financings and the earnings are pledged in support of the debt. Because the revenue stream of the student loan portfolios is pledged to support the debt, we are reporting condensed financial information about this segment.

Statements of revenues, expenses and changes in net assets

For the years ended June 30 (in thousands)		2004	2003
Interest revenue	$	**235,863**	211,663
Interest expense		**66,152**	82,395
Net interest revenue		**169,711**	129,268
Noninterest revenue		**537**	1,655
Total operating revenues		**170,248**	130,923
Operating expenses		**47,714**	39,932
Operating income		**122,534**	90,991
Grants and other financial aid		**20,248**	13,728
Net income		**102,286**	77,263
Transfers to unrestricted net assets		**(40,000)**	(39,555)
Change in net assets		**62,286**	37,708
Net assets, beginning of period		**225,926**	188,218
Net assets, end of period	$	**288,212**	225,926

Statements of net assets

At June 30 (in thousands)		2004	2003
Investments	$	**303,775**	384,313
Loans held for sale		**777,000**	-
Student loans receivable		**4,059,988**	4,140,653
Other, principally interest income receivable		**136,023**	121,860
Total assets		**5,276,786**	4,646,826
Notes and bonds payable, net		**4,969,397**	4,398,149
Other, principally accrued interest payable		**19,177**	22,751
Total liabilities		**4,988,574**	4,420,900
Net assets, restricted for debt service	$	**288,212**	225,926

Statements of cash flows

For the years ended June 30 (in thousands)		2004	2003
Interest received on student loans	$	**229,095**	196,544
Principal received on student loans		**540,962**	510,494
Student loan originations		**(705,334)**	(616,003)
Student loan purchases		**(962,115)**	(1,041,777)
Student loan sales and securitizations		**429,244**	144,958
Interest received on investments		**3,161**	6,840
Interest paid on student loan financings and bonds payable		**(69,058)**	(80,457)
Payment of operating expenses		**(46,740)**	(38,473)
Net cash used for operations		**(580,785)**	(917,874)
Proceeds from issuance of noncapital debt		**920,474**	1,736,779
Principal paid on noncapital debt		**(350,025)**	(700,086)
Other		**(62,712)**	(60,512)
Net cash provided by noncapital financing activities		**507,737**	976,181
Proceeds from sales and maturities of investments		**9,353,830**	13,129,551
Purchases of investments		**(9,273,292)**	(13,186,883)
Net cash provided by (used for) investing activities		**80,538**	(57,332)
Net change in cash and cash equivalents		**7,490**	975
Cash and cash equivalents, beginning of period		**9,048**	8,073
Cash and cash equivalents, end of period	$	**16,538**	9,048

Note 13 – Restrictions on Net Assets

Net assets restricted for debt service amounted to $293.6 million at June 30, 2004. Of that amount, $288.2 million is related to net assets held under various indentures related to financing our student loan portfolios. Under these indentures, we are required to maintain a parity ratio, a ratio of assets to liabilities, ranging from 1.0 to 1.03. At June 30, 2004, of the $288.2 million net assets restricted under these indentures, we have $104.0 million of excess parity that could be made available. However, to release funds from the restriction, we must satisfy the bond insurer or the provider of the financing that the withdrawal will not impair our ability to meet debt service requirements and maintain the required parity ratio on the underlying financing. The remaining $5.4 million of net assets restricted for debt service is related to capital and other financings.

The $61.4 million of net assets restricted for financial aid results from Commonwealth of Pennsylvania grants and federal grants related to specific programs. Those net assets are restricted until we disburse program-related grants.

The $6.5 million restricted for default aversion activities is restricted under federal law and remains restricted until we incur qualifying expenses.

Under Commonwealth law, our purpose is to increase higher education opportunities for Pennsylvania residents. Net assets that we report as unrestricted are statutorily restricted to our purpose. Furthermore, the Higher Education Amendments of 1998 restrict our use of net assets related to FFELP guaranty activities to fulfilling our guaranty responsibilities and other student financial aid related activities selected by us. Because that restriction is consistent with our statutory purpose, we consider net assets related to those activities also to be unrestricted.

Note 14 – Student Loan Securitizations

When we sell student loan receivables in securitizations of student loans, we enter into a servicing agreement with the securitization trust and earn annual servicing fees from the trust of 50 basis points per year on the outstanding balance of student loans in the securitization trust. We also enter an administration agreement with the trust and earn annual administration fees of 25 basis points per year on the outstanding balance of student loans in the trust. During the year ended June 30, 2004, we earned $1.6 million under these arrangements and that amount is included in servicing fees on the statement of revenues, expenses, and changes in net assets.

The securitization trust, PHEAA Student Loan Trust I, files a monthly Form 8-K with the SEC, and those filings are available on the SEC's website at www.sec.gov. Condensed financial information for the securitization trust as of June 30, 2004 follows.

(In thousands)		
Principal balance of financed student loans	$	**345,620**
Aggregate outstanding principal amount of notes	$	**373,472**

A residual interest results from the securitization of student loans, and we estimate based on current conditions that we will receive $9.2 million from this securitization trust through the years ending June 30, 2015 with the first receipts of $1.6 million occurring in the year ending 2006. Following GASB guidance, the residual interest is recognized as revenue when the cash flows become available to us.

Note 15 – Risk Management and Contingencies

We are exposed to various risks of loss, such as theft, damage to and destruction of assets, etc. To handle those risks, we generally purchase insurance coverage, but also participate in the Commonwealth's self-insurance program and there have been no material claims.

Federal programs in which we participate are subject to audit in accordance with the provisions of the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. The provisions of this circular do not limit the authority of ED or other federal audit officials to perform, or contract for, audits and evaluations of federal financial assistance programs. Therefore, our operations in current and prior years are subject to audit. We believe we are in substantial compliance with applicable federal regulations and that any adjustment because of future audits will not be material.

We are involved in various legal matters in the normal course of business. Considering available information, we do not believe that resolution of any such matters will have a material impact on the financial statements.