TEXAS STATE AFFORDABLE HOUSING CORPORATION

AUDITED FINANCIAL STATEMENTS AND SUPPLEMENTAL INFORMATION

August 31, 2006

With
Independent Auditor's Report

TEXAS STATE AFFORDABLE HOUSING CORPORATION

ANNUAL FINANCIAL REPORT
August 31, 2006

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TEXAS STATE AFFORDABLE HOUSING CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS

Fiscal Year Ended August 31, 2006

This discussion and analysis of Texas State Affordable Housing Corporation's (the "Corporation") financial performance provides an overview of the Corporation's financial activities for the fiscal year ended August 31, 2006. Please read it in conjunction with the accompanying transmittal letter, the basic financial statements and the accompanying notes to those financial statements.

FINANCIAL HIGHLIGHTS

- The assets of the Corporation exceeded its liabilities at the close of the Fiscal Year ending August 31, 2006 by approximately $6,311,000. Of this amount, $6,275,000 may be used to meet the Corporation's ongoing obligations to the public and the Corporation's creditors and $36,000 is invested in capital assets.

- Total assets and total liabilities increased largely due the issuance of approximately $75 million in Single Family Mortgage Revenue Bonds. These bonds were issued under the Professional Educators Home Loan Program and Fire Fighter and Law Enforcement or Security Officer Home Loan Program.

- The Corporation's total net assets decreased during Fiscal Year 2006 by approximately $3 million. Approximately $2 million of this decrease is attributable to the decrease in the fair value of investments. The Corporation follows the provisions of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools* which requires that certain types of investments to be reported at fair value on the balance sheet.

- Total operating revenues for Fiscal Year 2006 were approximately $6,123,000 and operating expenditures were $9,282,000 resulting in a net loss of $3,159,000.

OVERVIEW OF THE FINANCIAL STATEMENTS

The financial statements presented herein include all of the activities of the Corporation as prescribed by GASB Statement No. 34 which was implemented during Fiscal Year 2002. This annual report consists of the following:

1. Management's Discussion and Analysis
2. Financial Statements
3. Notes to the Financial Statements.

The Corporation operates as a single enterprise fund; therefore the basic financial statements presented are the Statement of Net Assets, Statement of Revenues, Expenses and Changes in Net Assets, and the Statement of Cash Flows. As with all proprietary funds, the financials are presented using the economic resources measurement focus.

The Statement of Net Assets and the Statement of Revenues, Expenses and Changes in Net Assets report information about the Corporation as a whole. These statements include *all* assets and liabilities of the Corporation using the *accrual basis of accounting*, which is similar to the accounting used by most private-sector companies. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

The Statement of Net Assets and the Statement of Revenues, Expenses and Changes in Net Assets report the Corporation's *net assets* and changes in them. Net assets are the difference between assets and liabilities, which is one way to measure the Corporation's financial health, or *financial position.* Over time, *increases or decreases* in the Corporation's net assets are one indicator of whether its *financial health* is improving or deteriorating.

The Corporation's activities are accounted for as a special purpose government, or single enterprise fund.

The Notes to the Financial Statements provide additional information that is essential to a full understanding of the data provided in the basic financial statements.

THE FINANCIAL STATEMENTS

Statement of Net Assets

Net assets decreased from $9,470,054 to $6,311,108 in Fiscal Year 2006. The decrease is attributable primarily to the net decrease in the fair value of investments ($1.7 million) and recognition of program grant expense ($2.5 million) related to the single family bond programs. Of the total net assets, $36,371 is invested in capital assets. The remaining balance of $6,274,737 is unrestricted and available for corporate programs, payment of obligations, and fulfillment of the Corporation's public purpose.

The Corporation's total assets increased from $95.7 million to $153 million during Fiscal Year 2006. The largest single factor contributing to this increase was the issuance of approximately $75 million in Single Family Mortgage Revenue Bonds. These bonds were issued for the purpose of making first lien, single family mortgage loans to eligible borrowers under the Corporation's Professional Educators Home Loan Program and Fire Fighter and Law Enforcement or Security Officer Home Loan Program.

The Corporation's current assets totaled $60,639,865 while current liabilities totaled $2,410,607.

Noncurrent assets consist primarily of restricted investments held by the bond trustee of $85,564,417; capitalized bond issuance costs of $2,310,454; the Corporation's loan portfolio equaling $1,507,179; notes receivable of $1,868,256; custodial cash and cash equivalents of $170,069 and purchased mortgage servicing rights totaling $1,145,059. The Corporation's capital assets, consisting of furniture, equipment and leasehold improvements total only $36,371, net of accumulated depreciation.

Noncurrent liabilities consist of bonds payable totaling $140,896,377; deferred revenue of $1,383,308; notes payable of $2,070,201 and custodial reserve funds totaling $170,069. Bonds payable increased primarily due to the issuance of approximately $75 million in Single Family Mortgage Revenue Bonds in 2006.

Statement of Revenues, Expenses and Changes in Net Assets

The Corporation reported $6.1 million in operating revenues during Fiscal Year 2006. Interest and Investment Income totaling $5,589,332, less the Decrease in Fair Value of Investments of $1,731,139, constitutes the largest source of income contributing 63% to total operating revenue for Fiscal Year 2006.

Asset Oversight and Compliance Fees totaled $566,757 and represent 9% of operating revenue for Fiscal Year 2006. Asset Oversight and Compliance Fees are derived from contracts with properties financed with multifamily bonds issued by the Corporation or the Texas Department of Housing and Community Affairs.

Loan Servicing activities include performing duties as Master Servicer for the Texas Department of Housing and Community Affairs and servicing the Corporation's own portfolio of single-family and multifamily loans. Loan Servicing Fees contributed $444,838 in revenue, reported net of subservicer fees of $144,389.

Single Family Servicing Fees are paid to the Corporation by the Master Servicer for the right to service loans originated under the Professional Educators Home Loan Program and the Fire Fighter and Law Enforcement or Security Officer Home Loan Program. Single Family Servicing Fees totaled $991,338 for Fiscal Year 2006 and represent 16% of total operating revenues.

Multifamily Bond Fees contributed only $98,113 or 2% of total operating revenues for Fiscal Year 2006. Multifamily programs primarily consist of the multifamily bond program, direct lending activities, and projects performed for the purpose of increasing and preserving the availability of affordable housing units throughout the state of Texas.

Operating expenses for the year totaled $9.3 million. The four largest expenses for Fiscal Year 2006 were Interest Expense on Bonds and Notes Payable (55%); Single Family Bond Grant Expense (27%); Salaries, Wages and Payroll Related Expenses (9%); and Amortization (3%). The Corporation recorded a net loss for Fiscal Year 2006 of $3,158,946. The most significant factors contributing to the loss were the net decrease in the fair value of investments and increases in interest expense and program grant expense for down payment assistance under the Single Family Bond Program.

BUSINESS TYPE ACTIVITIES

For the purposes of financial reporting, the Corporation is a special purpose government operating as a single enterprise fund. All activities of the Corporation are categorized as business type activities and are accounted for the in the Financial Statements and Management's Discussion and Analysis.

BUDGETARY HIGHLIGHTS

The Corporation is not required to adopt a legal budget and has not done so, therefore, no budgetary highlights or comparison are required.

RELEVANT DECISIONS AND ECONOMIC FACTORS

Public Purpose – The Corporation is organized, operated and administered exclusively for the promotion of social welfare, and is a section 115 and 501(c)(3) nonprofit corporation under the Internal Revenue Code of 1986, as amended. The Corporation's mission is to serve the housing needs of moderate and lower income Texans who are not afforded housing finance options through conventional lending channels.

CONTACTING THE CORPORATION'S FINANCIAL MANAGEMENT

This financial report is designed to provide our customers, investors, and creditors with a general overview of the Corporation's finances and to show the Corporation's accountability for the money it receives. If you have questions about this report or need any additional financial information, contact the Texas State Affordable Housing Corporation at 1005 Congress Avenue, Austin, TX 78701, phone 512-477-3555.

AUDITED FINANCIAL STATEMENTS

MIKESKA • MONAHAN • PECKHAM • LLP
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Texas State Affordable Housing Corporation
Austin, Texas

We have audited the accompanying statement of net assets of the Texas State Affordable Housing Corporation (the "Corporation"), a nonprofit corporation that is a component unit of the State of Texas, as of August 31, 2006 and the related statements of revenues, expenses and changes in fund net assets and cash flows for the year then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year summarized comparative information has been derived from the Corporation's 2005 financial statements and, in our report dated November 28, 2005, we expressed an unqualified opinion on those financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Texas State Affordable Housing Corporation as of August 31, 2006, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Governmental Auditing Standards,* we have also issued a report dated November 28, 2006, on our consideration of the Corporation's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Governmental Auditing Standards,* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 1 through 4 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 inquires of management regarding the methods of measurement and presentation of supplementary information. However, we did not audit the information and express no opinion on it.

Mikeska Monahan & Peckham, LLP

Austin, Texas
November 28, 2006

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TEXAS STATE AFFORDABLE HOUSING CORPORATION
STATEMENT OF NET ASSETS
As of August 31, 2006
with comparative amounts as of August 31, 2005

ASSETS	2006	2005
Current Assets:		
Cash and Cash Equivalents	$ 1,002,356	$ 2,409,851
Restricted Assets Held by Bond Trustee:		
Cash and Cash Equivalents	892,345	818,308
Short-term Investments, at Fair Market Value	52,200,144	42,435,668
Accrued Interest	730,555	183,359
Investments, at Fair Market Value	4,940,483	2,947,325
Accounts Receivable & Accrued Revenue, Net of uncollectible amts. of $1,588,212	558,039	748,394
Accrued Interest Receivable	37,252	15,195
Loans Receivable, Current Portion	92,743	44,475
Notes Receivable, Current Portion	161,567	21,750
Prepaid Expenses	24,381	23,764
Total Current Assets:	60,639,865	49,648,089
Noncurrent Assets:		
Loans Receivable, net of uncollectible amounts of $121,726	1,507,179	1,588,693
Notes Receivable	1,868,256	2,030,909
Mortgage Servicing Rights, Net of Accumulated Amortization of $1,583,002	1,145,059	1,297,069
Fixed Assets, Net of Accumulated Depreciation of $180,284	36,371	32,254
Custodial Cash and Cash Equivalents	170,069	154,173
Bond Issuance Costs, Net of Amortization of $329,698	2,310,454	1,162,174
Restricted Investments Held by Bond Trustee, at Fair Market Value	85,564,417	39,775,187
Total Noncurrent Assets:	92,601,805	46,040,459
TOTAL ASSETS:	**$ 153,241,670**	**$ 95,688,548**
LIABILITIES & NET ASSETS		
Current Liabilities:		
Accounts Payable and Accrued Expenses	$ 65,753	$ 61,412
Notes Payable, Current Portion	14,072	513,625
Other Current Liabilities	24,745	22,549
Payable from Restricted Assets Held by Bond Trustee:		
Bonds Payable, Current Portion	601,216	17,931,832
Accrued Interest on Bonds	1,704,821	509,923
Total Current Liabilities:	2,410,607	19,039,341
Noncurrent Liabilities:		
Multifamily Custodial and Reserve Funds	170,069	154,173
Notes Payable	2,070,201	1,033,276
Revenue Bonds Payable	140,896,377	65,173,369
Deferred Revenue	1,383,308	818,335
Total Noncurrent Liabilities:	144,519,955	67,179,153
Total Liabilities:	146,930,562	86,218,494
Net Assets:		
Invested in Capital Assets	36,371	32,254
Unrestricted Net Assets	6,274,737	9,437,800
Total Net Assets:	6,311,108	9,470,054
TOTAL LIABILITIES & NET ASSETS	**$ 153,241,670**	**$ 95,688,548**

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

TEXAS STATE AFFORDABLE HOUSING CORPORATION
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
For the Year Ended August 31, 2006
with comparative amounts for the year ended August 31, 2005

	2006	2005
Operating Revenues		
Interest and Investment Income	$ 5,589,332	$ 2,385,727
Net Increase/(Decrease) in Fair Value of Investments	(1,731,139)	460,633
Single Family Program Issuer and Servicing Fees	1,097,714	553,031
Asset Oversight and Compliance Fees, Net of bad debt of $646,879	566,757	695,354
Loan Servicing Fees, Net of subservicer fees of $144,389	444,838	572,434
Multifamily Bond Fees, Net of bad debt of $333,005	98,113	310,543
Grant Income	-	500,000
Other Operating Revenue	57,077	-
Total Operating Revenues	$ 6,122,692	$ 5,477,722
Operating Expenses		
Interest Expense on Bonds and Notes Payable	$ 5,096,001	$ 1,896,333
Single Family Program Grant Expense	2,469,335	1,390,386
Salaries, Wages and Payroll Related Costs	851,465	757,988
Professional Fees and Services	174,446	205,837
Amortization	280,646	481,604
Office and Equipment Rental and Maintenance	122,680	118,724
Travel and Meals	75,746	65,991
Depreciation	13,386	16,100
Program and Loan Administration	97,390	30,004
Other Operating Expenses	100,543	108,401
Total Operating Expenses	$ 9,281,638	$ 5,071,368
Net Income (Loss)	$ (3,158,946)	$ 406,354
Total Net Assets, Beginning	$ 9,470,054	$ 9,063,700
Total Net Assets, Ending	$ 6,311,108	$ 9,470,054

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

TEXAS STATE AFFORDABLE HOUSING CORPORATION
STATEMENT OF CASH FLOWS
For the Year Ended August 31, 2006
with comparative amounts for the year ended August 31, 2005

	2006	2005
Increase/(Decrease) in Cash and Cash Equivalents		
Cash Flows from Operating Activities		
Receipts from Customers & Users	$ 1,567,357	$ 2,618,475
Payments to Employees	(644,039)	(582,140)
Payments of Benefits & Other Payroll Related Costs	(201,534)	(170,601)
Payments to Suppliers of Goods & Services	(3,157,027)	(2,058,542)
Net Cash Used By Operating Activities	(2,435,243)	(192,808)
Cash Flows from Non-Capital Financing Activities		
Proceeds from the Sale of Bonds	74,719,733	51,727,728
Proceeds from Bond Premiums	3,847,408	2,331,284
Proceeds from Deferred Servicing Fees on Single Family Bond Program	993,085	239,250
Proceeds from Notes Payable	1,050,000	-
Payments of Principal on Notes Payable	(512,628)	(12,783)
Payments of Interest on Notes Payable	(69,577)	(84,306)
Payments of Interest on Single Family Bond Program	(3,757,346)	(1,917,542)
Payments for Bond Issuance Costs	(1,276,915)	(709,295)
Payments of Principal related to Bond Maturities and Calls	(19,789,378)	(31,195,760)
Net Cash Provided By Non-Capital Financing Activities	55,204,382	20,378,576
Cash Flows from Capital and Related Financing Activities		
Payments for Additions to Fixed Assets	(17,503)	(5,824)
Net Cash Used for Capital and Related Financing Activities	(17,503)	(5,824)
Cash Flows from Investing Activities		
Proceeds from Interest and Investment Income	5,042,136	2,024,450
Proceeds from Sale of Investments by Bond Trustee	64,360,718	32,281,035
Proceeds from Sale of Unrestricted Investments	6,586,885	5,508,053
Purchase of Investments by Bond Trustee	(121,642,864)	(54,495,535)
Purchase of Unrestricted Investments	(8,580,043)	(8,443,216)
Restricted Cash & Cash Equivalents Held by Bond Trustee	74,037	(214,290)
Net Cash Used By Investing Activities	(54,159,131)	(23,339,503)
Net Decrease in Cash and Cash Equivalents	(1,407,495)	(3,159,559)
Cash and Cash Equivalents at Beginning of Year	2,409,851	5,569,410
Cash and Cash Equivalents at End of Year	$ 1,002,356	$ 2,409,851

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

TEXAS STATE AFFORDABLE HOUSING CORPORATION
STATEMENT OF CASH FLOWS
For the Year Ended August 31, 2006
with comparative amounts for the year ended August 31, 2005

	2006	2005
Reconciliation of Operating Income to Net Cash Provided/(Used) by Operating Activities		
Net Income (Loss) from Operations	$ (3,158,946)	$ 406,354
Adjustments To Reconcile to Net Cash from Operations		
Recognition of Deferred Revenue	(625,633)	(146,594)
Depreciation and Amortization Expense	294,031	497,704
Unrealized (Gain) Loss on Investments	1,731,139	(460,633)
Forgiveness of Note Payable to TDHCA	-	(500,000)
Operating income and cash flow categories - Classification differences	(817,359)	839,128
Changes in Current Assets and Liabilities:		
(Increase)/Decrease in Accounts Receivable	190,355	116,284
(Increase)/Decrease in Accrued Interest Receivable	(22,057)	2,674
(Increase)/Decrease in Loans Receivable	33,246	86,818
(Increase)/Decrease in Notes Receivable	22,836	(477,848)
(Increase)/Decrease in Bond Issue Costs	(1,276,915)	(709,295)
Increase/(Decrease in Accounts Payable & Accrued Exp	4,341	24,330
Increase/(Decrease in Accrued Interest Payable	1,194,898	113,117
Increase/(Decrease in Other Assets & Liabilities, net	(5,179)	15,153
Net Cash Used by Operating Activities	$ (2,435,243)	$ (192,808)

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

TEXAS STATE AFFORDABLE HOUSING CORPORATION

ANNUAL FINANCIAL REPORT
August 31, 2006

INDEX FOR THE NOTES TO THE FINANCIAL STATEMENTS

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Activities

Reporting Entity - Texas State Affordable Housing Corporation (the "Corporation") was incorporated by the Texas Department of Housing and Community Affairs (the "Department") on May 6, 1994 under the Texas Non-Profit Corporation Act, Article 1396.1.01 et seq., Vernon's Annotated Texas Civil Statutes as amended, is legally separate from the State of Texas and does not receive State appropriated funding. Under Government Accounting Standards Board ("GASB") Statement 14, *The Financial Reporting Entity*, the Corporation is a special purpose government and component unit of the State of Texas for financial reporting purposes.

The Governing Board consists of five directors, all of which are appointed by the Governor of the State of Texas. The public purposes of the Corporation is to perform such activities and services that the Corporation's Board of Directors determines will promote the public health, safety, and welfare through the provision of adequate, safe and sanitary housing primarily for individuals and families of low, very low and extremely low income, and to perform activities and services related to this purpose and for other purposes as set forth in Chapter 2306, Subchapter Y, of the Government Code, as amended.

The Corporation is organized, operated and administered as a non-profit organization in accordance with Section 501(c)(3) of the Internal Revenue Code.

Dissolution of Entity - Upon dissolution of the Corporation, title to or other interest in real or personal property or rights thereto owned by the Corporation shall not be transferred to private ownership but shall be transferred and delivered to, and shall vest in, the Department.

The Corporation is subject to Chapter 325 of the *Texas Government Code* (Texas Sunset Act). Unless continued in existence as provided by the Texas Sunset Act, the Corporation will be abolished effective September 1, 2009.

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES - Continued

Basis of Presentation - The accompanying financial statements of the Corporation have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (the "GASB"). In June 1999 the GASB issued Statement 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments,* which established new financial reporting requirements for state and local governments throughout the United States. For financial reporting purposes, the Corporation is considered a special purpose government.

The Corporation was required to implement this standard for the fiscal year ending August 31, 2002; subsequent reporting, including the fiscal year ending August 31, 2006, includes the implementation of this standard. Comparability of current year financials with fiscal years prior to 2002 is affected by the new reporting requirements and the restructuring of financial information.

With the implementation of GASB Statement 34, the Corporation has prepared required supplementary information titled *Management's Discussion and Analysis* which precedes the basic financial statements. The Corporation is not required to adopt a legal budget and has not done so; therefore this report does not include a budgetary comparison.

In conjunction with GASB Statement 34, additional GASB Statements are required and were implemented by the Corporation in a prior fiscal year including: Statement 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, and Statement 38, *Certain Financial Statement Note Disclosures.*

Corporate Lines of Business

Servicing Operations

Servicing Operations account for the loan servicing activities of the Corporation. The operations during fiscal year 2006 reflect the Corporation's activities as Master Servicer for the Department's single-family mortgage revenue bond program issues 52, 53, and 54, and servicer of the Corporation's own portfolio of mortgage and multifamily loans, including some second lien mortgage loans originated under Housing Trust Fund grants.

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES – Continued

In its capacity as Master Servicer for bond programs 52, 53, and 54, the Corporation was responsible for acquiring loans from participating lenders by paying the lender a service release premium for the loan or loans acquired under the Department's bond programs, warehousing the loans, securitizing the loans and transferring the mortgage backed securities to the Department and/or the bond trustee. The Corporation retains the exclusive right to service the mortgage loans acquired under these bond programs.

The Corporation has subcontracted substantially all of the responsibilities of servicing related to the Department's single-family mortgage revenue bond program issues 52, 53 and 54 to Countrywide Home Loans, Inc. ("CHL"). To compensate CHL for their sub-servicing duties, CHL receives a sub-servicing fee and all ancillary fee income for the loans CHL sub-services.

Asset Oversight and Compliance

Asset Oversight – These operations are used to account for monitoring activities performed by the Corporation for multifamily bond properties for which the Department acted as issuer or the Corporation acted a conduit issuer. The Corporation receives an annual fee based on either the number of units serviced or a percentage of the outstanding bond balance. The Corporation serves as an agent for the Department under 92 asset oversight agreements. The Corporation's asset oversight portfolio includes 8 asset oversight agreements covering 36 properties.

Compliance – Multifamily mortgage revenue bonds for which the Corporation acts as a conduit issuer require monitoring in order to ensure that the borrower is in compliance with specific bond regulations overseeing tax-exempt bonds. Compliance monitoring is accomplished by performing in-house and on-site monitoring reviews.

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES – Continued

Single Family Lending Operations

Single Family Bond Program – Effective June 15, 2001, the 77th Texas Legislature amended the Corporation's mission to include the creation of the Teachers Home Loan Program. HB 3451 states that out of the portion of the state ceiling that is available exclusively for reservations by issuers of qualified mortgage bonds under Section 1372.022, *Texas Government Code*, $25 million shall be allotted each year and made available exclusively to the Corporation for the purpose of issuing qualified mortgage bonds in connection with the teachers home loan program, established under Section 2306.562, *Texas Government Code,* as amended.

Effective September 1, 2003, SB 284, created during the 78th Legislature, revised the program participant qualifications by eliminating the three and five year restrictions and modifying the participant qualifications to include professional educators, not just classroom teachers. The revised program was renamed the Professional Educators Home Loan Program.

The proceeds from the sale of bonds are used to originate single-family mortgage loans exclusively for eligible borrowers in Texas. The Program is offered on a first-come, first-served basis, to first-time homebuyers who wish to purchase a newly constructed or existing home. Under the program, eligible teachers, teacher's aides, school nurses, school counselors, and school librarians are able to apply for a 30- year fixed rate mortgage loan and obtain a grant for down payment assistance in an amount equal to approximately 5% of the purchase price.

Effective June 20, 2003, HB 1247, created during the 78th Legislature, amended the Corporation's mission to include the creation of the Fire Fighter and Police Officer Home Loan Program. HB 1247 states that out of the portion of the state ceiling that is available exclusively for reservations by issuers of qualified mortgage bonds under Section 1372.022, *Texas Government Code*, $25 million shall be allotted each year and made available exclusively to the Corporation for the purpose of issuing qualified mortgage bonds in connection with the firefighter and police officer home loan program established under Section 2306.563, *Texas Government Code*, as amended.

Effective September 1, 2005, HB 1007, created during the 79th Legislature, revised the program participant qualifications to include corrections officers, county jailers, public security officers, and peace officers, not just fire fighters

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES – Continued

and police officers. The revised program was renamed the Fire Fighter and Law Enforcement or Security Officer Home Loan Program.

The proceeds from the sale of bonds are used to originate single-family mortgage loans exclusively for eligible borrowers in Texas. The Program is offered on a first-come, first-served basis, to first-time homebuyers who wish to purchase a newly constructed or existing home. Under the program, eligible fire fighters, peace officers, corrections officers, county jailers, and public security officers are able to apply for a 30- year fixed rate mortgage loan and obtain a grant for down payment assistance in an amount equal to approximately 5% of the purchase price.

Affordable Homeownership Program for Texas - In 2004, the Corporation partnered with Ameriquest Mortgage Company ("Ameriquest") to develop a mortgage financing program for eligible low-to-moderate income Texans that are not able to meet the traditional lending requirements. The Program rewards borrowers for making timely mortgage payments by offering lower interest rates and lower mortgage payments. Through their combined efforts, Ameriquest and the Corporation will provide borrowers with an affordable mortgage loan product and down payment assistance equal to 7% of the mortgage loan amount. The Corporation has committed $1 million dollars for down payment assistance; Ameriquest has committed $100 million for mortgage loans.

Multifamily Programs and Operations

Multifamily 501(c)(3) Bond Program – The Corporation acts as a conduit issuer of mortgage revenue bonds for qualified 501(c)(3) owners of multifamily housing developments. Each multifamily property must agree to restrict a certain number of the units so that they are affordable in their market place. Additionally, each owner must provide significant resident and/or community services with its excess revenues. In exchange for these contributions, the owner will receive a below market mortgage rate provided through the issuance of tax-exempt mortgage revenue bonds. See Note 16.

Multifamily Private Activity Bond Program – Under the Multifamily Private Activity Bond ("PAB") Program, the Corporation administers 10 percent of the State's volume cap allocation of private activity bonds for multifamily residential rental housing each year. For the 2006 program year the amount available for

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES – Continued

issuance was approximately $40 million. The Corporation's Multifamily PAB Program provides financing for new construction, or acquisition and rehabilitation of existing multifamily rental properties. The Corporation is required by statute to target areas, such as cities and counties, and to issue requests for proposals to developers to provide the type of housing requested by the target area. In exchange for receiving the lower tax-exempt revenue bond interest rate, multifamily complexes financed through this program must provide a minimum number of affordable units.

Multifamily Direct Lending – The Multifamily Direct Lending Program provides financing for the purpose of increasing and preserving the stock of affordable multifamily housing units provided in Texas. Lending efforts are targeted to all reputable entities engaged in affordable housing development that focus on rural Texas and small cities, as well as other underserved and difficult to develop areas. See Note 4.

Significant Accounting Policies

Basis of Accounting – The Corporation prepares its financial statements using the economic resources measurement focus and the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when the liability is incurred regardless of the timing of the related cash flow.

Cash Equivalents - For the purpose of reporting cash flows, cash and cash equivalents consist of cash and short-term investments with a maturity at the date of purchase of three months or less, which are highly liquid, and can be readily exchanged for cash at amounts equal to their stated value.

Marketing Costs – The Corporation expenses the cost of advertising and promotion as they are incurred.

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES – Continued

Investments – The Corporation follows the provisions of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. GASB Statement No. 31 requires certain types of investments to be reported at fair value on the balance sheet. The Corporation utilizes established quoted market prices for determining the fair value of its debt securities in reserve funds. Fair value of the Corporation's securitized mortgage loans ("GNMA/FNMA") has been estimated by each bond issues' trustee using a pricing service.

In accordance with GASB Statement No.31, changes in the fair value of investments are reported in the statement of revenues, expenses and changes in net assets as net increase/(decrease) in fair value of investments.

Loans Receivable - Mortgage loans originated by the Corporation are carried at the unpaid principal balance outstanding, net of allowances for possible loan loss. Mortgage loans purchased by the Corporation are carried at the amortized cost of loans acquired, net of allowance for possible loan loss.

The Corporation has 29 Demonstration Down Payment loans, which are zero percent interest loans with a 5-year waiting period before monthly payments begin. Due to the uncertainty of repayment, the Corporation recorded these loans at the amount of assistance provided and included in deferred revenue an amount equal to the outstanding balance of the loan in previous years. As payments are received from the borrower the principal is reduced. A corresponding amount of servicing revenue is recognized for the portion of principal reduced with each payment allowing for a 1:1 ratio to exist between the remaining loan receivable and the balance of deferred revenue. See Note 9.

Notes Receivable – Notes receivable is comprised of loans made under the Multifamily Direct Lending Program, the Multifamily Private Activity Bond Program and in connection with the sale of the Town Oaks Apartments. Notes are carried at the unpaid principal balance outstanding.

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES – Continued

Allowance for Possible Losses - Losses are charged to the Allowance for Possible Loan Losses when the loss actually occurs or when a determination is made that a loss is likely to occur. During the year, management estimates the level of future losses to determine whether the allowance for possible loan losses is adequate to absorb anticipated losses in the existing mortgage loans. Based on these estimates, a provision for possible losses on loans is credited to the allowance in order to adjust the allowance to levels estimated to be adequate to absorb reasonably foreseeable losses.

While management uses available information to recognize losses in the loan portfolio, future adjustments may be necessary due to changes in economic conditions. However, it is the judgment of management that the allowances are currently adequate to absorb reasonably foreseeable losses in the existing portfolios.

Amortization of Bond Issuance Costs –Capitalized bond issuance costs related to the Single Family Bond Programs totaled approximately $2,640,000. Bond issuance costs are amortized over the life of the bonds (32 to 34 years). Prepayments on bonds result in the proportionate amortization during the current year of the remaining balance of capitalized bond issuance costs. Amortization expense for Fiscal Year 2006 totaled approximately $129,000; accumulated amortization as of August 31, 2006 equaled approximately $330,000.

Amortization of Bond Premium – The premiums related to the Single Family Bond Programs range from 104.00 to 109.54 and are amortized using the effective interest method. Prepayments on the bonds result in the proportionate amortization during the current year of the remaining balance of premiums on debt. Amortization of the bond premium for Fiscal Year 2006 totaled approximately $385,000; accumulated amortization as of August 31, 2006 equaled approximately $683,000.

Amortization of Purchase Mortgage Servicing Rights - Purchase Mortgage Servicing Rights are recorded at cost and are amortized in relation to the remaining value of the related mortgage balances at the end of each period so that the value of the servicing rights equals the same percentage of the outstanding mortgage balance as when originally purchased. Amortization expense for Fiscal Year 2006 was approximately $152,000; accumulated amortization as of August 31, 2006 equaled approximately $1,583,000.

NOTE 1: NATURE OF ACTIVITIES AND SIGNIFICANT ACCOUNTING POLICIES – Continued

Fixed Assets - All fixed assets are valued at historical cost or estimated historical cost if actual historical cost is not available. Donated fixed assets are valued at their estimated fair market value on the date donated. Expenses for betterments that materially extend the useful life of an asset are capitalized at cost. Depreciation is recorded using the straight-line method over the estimated useful lives of the assets, usually 3 to 5 years. The Corporation capitalizes fixed assets with a cost greater than $500 and a useful life of more than one year.

Compensated Absences - Employees of the Corporation earn annual leave on a monthly basis. Each employee is entitled to earned but unused annual leave pay up to a maximum 168 hours if employed less than two years, 232 hours if employed less than five years, and 256 if employed less than ten years, as compensation upon termination of employment. The total compensated absences accrued liability for the year ended August 31, 2006 was approximately $29,000.

Reserve and Custodial Accounts – The Corporation holds certain cash reserves totaling $170,000 for the benefit of two multifamily projects that are financed by the Corporation.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications – Certain amounts in the prior-year financial statements have been reclassified for comparative purposes to conform to the presentation in the current-year financial statements.

Comparative Financial Information – The financial statements include certain prior-year comparative information. Such information does not include sufficient detail to constitute a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the Corporation's financial statements for the year ended August 31, 2005, from which the comparative information was derived.

NOTE 2: CASH, CASH EQUIVALENTS AND INVESTMENTS

Cash and Cash Equivalents

Cash and cash equivalents at August 31, 2006 consist of bank deposits totaling $95,812, money market mutual funds totaling $145,733, deposits in the Federal Home Loan Bank totaling $70,955, and pooled investment funds totaling $689,856.

Restricted cash and cash equivalents at August 31, 2006 total $892,345 and are maintained in money market mutual funds by the bond trustee. The Corporation also maintains six custodial accounts with a combined total of $170,069 pledged as reserves on two multifamily projects. These funds are maintained in interest bearing demand accounts.

Investments

The Corporation's unrestricted investments consist of the following:

Description/Maturity	Interest Rate	Cost	Fair Market Value	Unrealized Gain/(Loss)
Fannie Mae Discount Note - 09/06/06	4.963%	$ 509,799	$ 521,695	$ 11,896
Freddie Mac Discount Note - 09/26/06	5.004%	499,537	510,228	10,691
Fannie Mae Discount Note - 10/18/06	5.168%	1,044,309	1,061,987	17,678
Fannie Mae Discount Note - 11/01/06	5.186%	517,070	525,463	8,393
Freddie Mac Discount Note - 12/29/06	5.241%	256,886	260,533	3,647
Freddie Mac Discount Note - 01/09/07	5.520%	277,448	279,768	2,320
Freddie Mac Discount Note - 01/19/07	5.546%	527,520	533,251	5,731
Freddie Mac Discount Note - 02/06/07	5.552%	729,610	736,239	6,629
Freddie Mac Discount Note - 03/05/07	5.357%	510,519	511,319	800
Total		$ 4,872,698	$ 4,940,483	$ 67,785

NOTE 2: CASH, CASH EQUIVALENTS AND INVESTMENTS – Continued

The Corporation's investments held by the bond trustee are summarized as follows:

Description/Maturity	Interest Rate	Cost	Fair Market Value	Unrealized Gain/(Loss)
Short-Term Investments				
Guaranteed Investment Contract - 12/01/06	3.63%	$ 3,339,677	$ 3,339,677	$ -
Guaranteed Investment Contract - 10/01/07	4.33%	8,126,131	8,126,131	-
Guaranteed Investment Contract - 10/01/07	5.11%	25,073,159	25,073,159	-
Guaranteed Investment Contract - 12/01/07	4.74%	15,661,177	15,661,177	-
Total		$ 52,200,144	$ 52,200,144	$ -
Long-Term Investments				
Guaranteed Investment Contract - 03/01/34	4.80%	$ 204,567	$ 204,567	$ -
Guaranteed Investment Contract - 03/01/34	3.75%	297,520	297,520	-
Guaranteed Investment Contract - 03/01/34	3.41%	238,322	238,322	-
Guaranteed Investment Contract - 09/01/39	3.05%	644,208	644,208	-
Guaranteed Investment Contract - 09/01/39	3.83%	246,620	246,620	-
GNMA/FNMA Investments - 2032/2033	6.71%	1,095,785	1,119,983	24,198
GNMA/FNMA Investments - 2032/2033	6.02%	2,918,744	2,928,372	9,628
GNMA/FNMA Investments - 2032/2033	5.74%	2,569,647	2,563,897	(5,750)
GNMA/FNMA Investments - 2034	5.45%	3,500,616	3,450,494	(50,122)
GNMA/FNMA Investments - 2034	5.80%	2,035,838	2,033,313	(2,525)
GNMA/FNMA Investments - 2034	5.99%	7,373,463	7,430,502	57,039
GNMA/FNMA Investments - 2034	5.87%	3,768,179	3,776,079	7,900
GNMA/FNMA Investments - 2034	5.75%	3,973,848	3,956,992	(16,856)
GNMA/FNMA Investments - 2034/2035	5.49%	2,001,563	1,975,668	(25,895)
GNMA/FNMA Investments - 2035	5.60%	1,863,276	1,842,546	(20,730)
GNMA/FNMA Investments - 2035	5.45%	4,800,661	4,727,531	(73,130)
GNMA/FNMA Investments - 2035	5.40%	3,288,924	3,237,183	(51,741)
GNMA/FNMA Investments - 2035	5.39%	3,654,856	3,587,927	(66,929)
GNMA/FNMA Investments - 2035	5.34%	154,555	151,226	(3,329)
GNMA/FNMA Investments - 2035/2036	5.45%	20,536,552	20,191,742	(344,810)
GNMA/FNMA Investments - 2036	5.49%	12,274,388	12,067,469	(206,919)
GNMA/FNMA Investments - 2036	5.49%	8,967,123	8,892,256	(74,867)
Total		$ 86,409,255	$ 85,564,417	$ (844,838)

NOTE 2: CASH, CASH EQUIVALENTS AND INVESTMENTS – Continued

Investments – Continued

Interest income on investments held by the bond trustee includes the following amounts:

Single Family Mortgage Revenue Bonds Series 2002	$	444,377
Single Family Mortgage Revenue Bonds Series 2004		2,091,259
Single Family Mortgage Revenue Bonds Series 2005A & B		1,796,243
Single Family Mortgage Revenue Bonds Series 2006A & B		864,867
	$	5,196,746

The net decrease in the fair value of investments held by the bond trustee totaled $1,731,139. The Corporation uses Government Accounting Standards Board (GASB) Statement 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools.* GASB Statement 31 requires investments to be reported at fair value at the balance sheet date rather than at cost, except for money-market investments and participating interest-earning investment contracts and certain external investment pools, which may be reported at fair value or at amortized cost, provided that the fair value of these investments is not significantly affected by the impairment of the credit standing of the issuer or by other factors. In addition, GASB Statement 31 also affects the way in which unrealized gains and losses are recognized for financial reporting purposes.

Credit Risk

The primary stated objective of the Corporation's adopted Investment Policy is the safety of principal and avoidance of principal loss. Credit risk within the Corporation's portfolio among the authorized investments approved by the Corporation's adopted Investment Policy is represented only in time and demand deposits, repurchase agreements, commercial paper, and non-rated SEC registered money market mutual funds. All other investments are rated AAA, or equivalent, by at least one nationally recognized rating agency. Investments are made primarily in obligations of the US Government, its agencies or instrumentalities.

NOTE 2: CASH, CASH EQUIVALENTS AND INVESTMENTS – Continued

State law and the Corporation's adopted Investment Policy restrict both time and demand deposits, including certificates of deposit, to those banks doing business in the State of Texas and further requires full insurance and/or collateral from these depositories (banks and savings banks). Certificates of deposit are limited to a stated maturity of one year. Collateral, with a 102% margin, is required and collateral is limited to obligations of the US Government, its agencies or instrumentalities. Independent safekeeping is required outside the pledging bank's holding company with monthly reporting. Securities are priced at market on a daily basis as a contractual responsibility of the bank.

By adopted Policy and state law, repurchase agreements are limited to those with defined termination dates executed with a Texas bank or a primary dealer (as defined by the Federal Reserve). The agreements require an industry standard, written master repurchase agreement and a minimum 102% margin on collateral as well as delivery versus payment settlement and independent safekeeping. Repurchase agreements may not exceed one year to stated maturity. Reverse repurchase agreements may not exceed 90 days after the term of the reverse and funds may be used only to acquire authorized investments matched to the reverse.

State law and the adopted Policy require that commercial paper have a maximum stated maturity of 90 days or less and be rated A1/P1 or its equivalent by at least two nationally recognized rating agencies.

The Corporation's adopted Investment Policy restricts investment in SEC registered mutual funds to money market mutual funds striving to maintain a $1 net asset value and with a weighted average maturity of 90 days as further defined by State law. Neither the state law nor the Policy requires a rating.

Local government investment pools in Texas are required to be rated AAA, or equivalent, by at least one nationally recognized rating agency. The adopted Policy further restricts investments to AAA-rated, "2a-7 like" (constant dollar) local government investment pools.

NOTE 2: CASH, CASH EQUIVALENTS AND INVESTMENTS – Continued

As of August 31, 2006,

- investment in an independent local government investment pool represented 12.28% of the total portfolio,
- holdings in a AAA-rated money market mutual fund represented 2.35 % of the total portfolio,
- funds invested in fully collateralized interest bearing accounts represented 5.66 % of the total portfolio, and
- holdings in US Government sponsored enterprise securities rated AAA and fully collateralized bank deposits represented 79.71% of the total portfolio.

Concentration of Credit Risk

The Corporation recognizes over-concentration of assets by market sector or maturity as a risk to the portfolio. The Corporation's adopted Investment Policy establishes diversification as a major objective of the investment program. The Policy requires that no issuer or institution represent more than 50% of the total portfolio with the exception of US Treasuries. Further diversification requirements established by Policy are:

	Max % of Portfolio
US Obligations	80%
Obligations of US Agencies	70%
Certificates of Deposit	25%
By Institution	10%
Repurchase Agreements	30%
Money Market Mutual Funds	25%
Commercial Paper	30%
By Issuer	10%
Local Government Stable Net Asset Value Pools	75%

As of August 31, 2006, funds invested in fully collateralized interest bearing accounts represented 5.66 % of the total portfolio.

Interest Rate Risk

In order to limit interest and market rate risk from changes in interest rates, the Corporation's adopted Investment Policy sets a maximum stated maturity for US obligations of 3 years. Collaterlized mortgage obligations have a stated maturity limitation of 10 years as set by state law. Certificates of deposit are restricted to a maturity of one year and commercial paper 90 days. The Policy sets a maximum weighted average maturity of six months.

NOTE 2: CASH, CASH EQUIVALENTS AND INVESTMENTS – Continued

As of August 31, 2006, the portfolio contained:

- no holding with a stated maturity date beyond six months, and
- the weighted average of the combined portfolio was 76 days on the total portfolio.

As of August 31, 2006, the portfolio contained no securities or structured notes which might be affected by interest rate risk.

Custodial Credit Risk

To control custody and safekeeping risk, State law and the Corporation's adopted Investment Policy require collateral for all time and demand deposits, as well as collateral for repurchase agreements, be transferred delivery versus payment and held by an independent party approved by the Corporation and held in the Corporation's name. The custodian is required to provide original safekeeping receipts and monthly reporting of positions with position descriptions including market value. Repurchase agreements and deposits must be collateralized to 102% and be executed under written agreements. Depository agreements are executed under the terms of FIRREA. The counter-party of each type transaction is held contractually liable for monitoring and maintaining the required collateral margins on a daily basis.

As of August 31, 2006, the portfolio contained no certificates of deposit and no repurchase agreements. All pledged bank collateral for demand deposits was held by an independent institution outside the bank's holding company.

NOTE: 3 LOANS RECEIVABLE

Loans receivable represents loans made under the Housing Initiatives Program, Housing Trust Fund Program, and loans purchased by the Corporation through the Affordable Home Ownership Program. Loans are carried at the unpaid principal balance, net of loss allowances.

A summary of loans receivable at August 31, 2006 is as follows:

Loans Receivable at September 1, 2005	$	1,754,893
Additions		59,497
Paydowns		(82,806)
Reduction due to Foreclosure and Short Sale		(9,936)
Loans Receivable at August 31, 2006		1,721,648
Allowance for possible loan losses		(121,726)
Net Balance at August 31, 2006	$	1,599,922

The current portion of loans receivable at August 31, 2006 is $92,743; the remaining balance of $1,507,179 is classified as noncurrent loans receivable.

The activity for allowance for loan losses for fiscal year 2006 is as follows:

Balance at September 1, 2005	$	(121,726)
Current Year Reduction		-
Loss Applied to the Allowance		-
Balance at August 31, 2006	$	(121,726)

The Corporation considers loans receivable to be delinquent when they become more than 60 days past due. At August 31, 2006, the Corporation had delinquent loans receivable of approximately $90,000.

NOTE 4: NOTES RECEIVABLE

Notes receivable is comprised of loans made under the Multifamily Direct Lending Program, the Multifamily Private Activity Bond Program and in connection with the sale of the Town Oaks Apartments. Notes are carried at the unpaid principal balance outstanding.

MF Direct Lending – By utilizing the Corporation's relationship with Federal Home Loan Bank (FHLB), on September 17, 2003, the Corporation provided permanent financing for: (1) the new construction of a 60-unit multifamily affordable housing development in Brady, Texas in the amount of $875,000; and, (2) the new construction of a 44-unit multifamily affordable housing development in Stephenville, Texas in the amount of $550,000.

The $875,000 note receivable requires monthly payments of principal and interest beginning November 1, 2003. The interest rate on the note is 7.75% with a 30 year amortization and 19 year term (balloon payment).

The $550,000 note receivable requires monthly payments of principal and interest beginning November 1, 2003. The interest rate on the note is 7.00% with a 30 year amortization and 19 year term (balloon payment).

Town Oaks Apartments – The Corporation sold the Town Oaks Apartments on September 11, 2003 and accepted as payment, a promissory note in the amount of $161,000. The terms of the note calls for annual principal reductions equal to five percent (5%) of the outstanding note balance. Interest is to be paid quarterly at the Prime Rate published in the *Wall Street Journal* plus one percent (1%). The balance of the note plus accrued and unpaid interest was paid on September 11, 2006.

Marshall Meadows Apartments
The Corporation provided private activity bond financing for the construction of a 250-unit multifamily complex known as Marshall Meadows Apartments in San Antonio, Texas (See Note 16). The Corporation also loaned $500,000 of unrestricted cash reserves for the construction. The note, dated January 7, 2005 will be paid back at 3 percent (3%) interest out of cash flows from the development. Sixty percent of the units in the apartment complex will be set aside for residents at or below 60 percent of the area median income. Forty percent of the units will be set aside for market rate residents.

NOTE 4: NOTES RECEIVABLE – Continued

A summary of notes receivable at August 31, 2006 is as follows:

Balance at September 1, 2005	$	2,052,659
Additions		-
Collections		(22,836)
Balance at August 31, 2006	$	2,029,823

The current portion of notes receivable at August 31, 2006 is $161,567; the remaining balance of $1,868,256 is classified as non-current notes receivable. Management considers these loans fully collectible. Accordingly, no provision has been made for uncollectible amounts.

NOTE 5: FIXED ASSETS

Fixed Assets held by the Corporation for 2006 consists of the following:

	COST OR BASIS OF PROPERTY			
	Balance September 1, 2005	Additions	Deletions	Balance August 31, 2006
Office Furniture & Equipment	$ 199,151	$ 17,503	-	$ 216,654

	ACCUMULATED DEPRECIATION			
	Balance September 1, 2004	Additions	Deletions	Balance August 31, 2005
Office Furniture & Equipment	$ 166,897	$ 13,386	-	$ 180,283

Fixed Assets less accumulated depreciation at August 31, 2006 totaled $36,371.

NOTE 6: INCOME TAX STATUS

Texas State Affordable Housing Corporation, a nonprofit corporation operating under section 501(c)(3) of the Internal Revenue Code, is generally exempt from federal income taxes and, accordingly, no provision for income taxes is included in the financial statements. The Corporation is classified as a nonprofit organization other than a private foundation.

NOTE 7: OPERATING LEASES

The Corporation leases office space under a five year lease agreement which calls for monthly lease payments of approximately $8,600. The monthly lease payments escalate annually by approximately $1,100. In addition, the Corporation pays a pro-rata share of the increase in building operating expenses. The corporation incurred rent expense of approximately $104,000 during Fiscal Year 2006 under this lease.

The Corporation also leased certain office equipment under a five-year lease agreement which terminated in July 2006. The corporation incurred rent expense of approximately $16,000 during the current year under this lease. A new agreement to lease office equipment was executed in August 2006. The agreement has a five year term and calls for monthly lease payments of $915 beginning September 2006.

The future minimum lease payments under the agreements are as follows:

Year Ended August 31,	Amount
2007	$ 116,607
2008	119,220
2009	10,980
2010	10,980
2011	10,980
Total Minimum Future Rental Payments	**$ 268,767**

NOTE 8: MULTIFAMILY RESERVES & CUSTODIAL ACCOUNTS

The Corporation holds certain cash reserves for the benefit of two multifamily projects that were financed by the Corporation through the Multifamily Direct Lending Program (See Note 4).

Reserve activity for the year ended August 31, 2006 is as follows:

Balance at September 1, 2005	$ 154,173
Deposits	22,655
Disbursements	(6,759)
Balance at August 31, 2006	$ 170,069

NOTE 9: DEFERRED REVENUE

In a prior year, the Corporation received $679,800 from the Department's Housing Trust Fund for the origination of down payment and closing cost assistance loans for households who earn less than 60% of the area median family income. The Corporation established a loan receivable for each loan made with a corresponding offset to deferred revenue. Recognition of the deferred revenue occurs as loans are repaid. Revenue recognized during Fiscal Year 2006 totaled approximately $17,000. The remaining deferred revenue for this portfolio is $500,916.

Deferred revenue also includes amounts that resulted from the sale of master servicer rights associated with the bond programs. Revenue is recognized as mortgage loans are pooled and GNMA or FNMA securities are purchased. The balance of deferred revenue related to the bond programs is $882,392.

A summary of deferred revenue activity for fiscal year 2006 is as follows:

Balance at September 1, 2005	$	818,335
Additions		1,188,731
Revenue Earned		(606,760)
Loan Payments Received		(16,998)
Balance at August 31, 2006	$	1,383,308

NOTE 10: NOTES PAYABLE

To provide mortgages under the HOME program, the Corporation obtained a $500,000 loan from the Department. The note at zero percent interest was repaid to the Department in full during fiscal year 2006.

During Fiscal Year 2004 the Corporation provided permanent financing for: (1) the new construction of a 60-unit multifamily affordable housing development in Brady, Texas in the amount of $875,000; and, (2) the new construction of a 44-unit multifamily affordable housing development in Stephenville, Texas in the amount of $550,000. The Corporation used unrestricted assets to fund 25% of each loan. Federal Home Loan Bank ("FHLB") funded the remaining 75% resulting in two loans payable from the Corporation totaling $1,068,750 at 6.345% with a 30 year amortization and 20 year term (balloon payment). The unpaid balance of the FHLB advances at August 31, 2006 was $1,034,273.

NOTE 10: NOTES PAYABLE - Continued

In May 2006 the Corporation entered into an agreement with Wells Fargo Community Development Corporation and received a loan in the amount of $1,050,000. Loan funds are to be used to fund an Interim Construction Loan Program, Multifamily Gap Financing Program or Down Payment Assistance Program. The loan is to be repaid in 10 years at 2% interest.

The summary of notes payable for the year ended August 31, 2006 is as follows:

Balance at September 1, 2005	$	1,546,901
Advances		1,050,000
Repayments/Forgiven		(512,628)
Balance at August 31, 2006	$	2,084,273

The current portion of notes payable at August 31, 2006 is $14,072; the remaining balance of $2,070,201 is classified as noncurrent notes payable.

The debt service requirements on long-term borrowings (i.e. notes payable) for the next five years and thereafter are as follows:

2007	$	101,063
2008		101,063
2009		101,063
2010		101,063
2011		101,063
Thereafter		2,932,196
Total		3,437,511
Less Interest		(1,353,238)
Outstanding Debt Obligations	$	2,084,273

NOTE 11: BONDED INDEBTEDNESS

The Corporation had nineteen (19) bonds series outstanding as of August 31, 2006. All series are single family mortgage revenue bonds backed by the pledged revenue sources and restricted funds specified in the bond resolutions. Each series is designed to be self-supporting with no repayment or obligation from the State of Texas or any political subdivision thereof. The Corporation issues bonds to assist in financing the purchase of homes by, or the construction of rental housing for, families with low to moderate incomes. Loan payments provide the revenues for debt service payments. Interest on bonds is payable semiannually or monthly.

There are a number of limitations and restrictions contained in the various single family bond indentures. The Corporation is in compliance with all significant limitations and restrictions at August 31, 2006.

A summary of deferred bond issuance costs for fiscal year 2006 follows:

Bonds Costs of Issuance

	Balance 09/01/2005	Additions	Deletions	Balance 08/31/2006
2002	$ 346,253	$ -	$ -	346,253
2004	616,919	80,040	-	696,959
2005A	400,064	6,250	-	406,314
2005B	-	366,103	-	366,103
2006A	-	413,640	-	413,640
2006B	-	410,883	-	410,883
	$ 1,363,236	$ 1,276,916	$ -	$ 2,640,152

Amortization of Bond Costs of Issuance

	Balance 09/01/2005	Additions	Deletions	Balance 08/31/2006
2002	$ 183,589	$ 22,636	$ -	$ 206,225
2004	17,473	77,851	-	95,324
2005A	-	10,940	-	10,940
2005B	-	8,984	-	8,984
2006A	-	6,155	-	6,155
2006B	-	2,070	-	2,070
	$ 201,062	$ 128,636	$ -	$ 329,698

NOTE 11: BONDED INDEBTEDNESS - Continued

CHANGES IN BONDS PAYABLE

Description	Interest Rate	Bonds Outstanding 9/1/05	Bonds Issued	Bonds Matured/ Retired	Bonds Refunded/ Extinguished	Bonds Outstanding 8/31/06	Amounts Due Within One Year
Single Family 2002							
Series 2002	Variable	-	-	-	-	-	-
Series 2002-1	6.01%-7.10%	$ 2,035,000	-	$ 490,000	-	$ 1,545,000	$ 10,000
Series 2002-2	5.64%-6.20%	3,120,000	-	405,000	-	2,715,000	20,000
Series 2002-3	5.65%-5.70%	2,945,000	-	235,000	-	2,710,000	30,000
Single Family 2004							
Series 2004A	1.62%	17,170,732	-	17,170,732	-	-	-
Series 2004-B1	5.40%	3,564,959	-	59,677	-	3,505,282	28,925
Series 2004-B2	5.75%	2,203,479	-	163,432	-	2,040,047	15,639
Series 2004-B3	5.95%	7,500,724	-	119,909	-	7,380,815	54,360
Series 2004-B4	5.80%	4,325,696	-	552,790	-	3,772,906	28,029
Series 2004-B5	5.65%	4,147,579	-	62,246	-	4,085,333	30,814
Series 2004-B6	5.45%	2,308,885	-	305,393	-	2,003,492	15,731
Series 2004-B7	5.55%	1,961,687	-	80,944	-	1,880,743	14,216
Series 2004-B8	5.30%	4,870,470	-	64,669	-	4,805,801	36,874
Series 2004-B9	5.30%	-	3,335,594	42,582	-	3,293,012	25,010
Series 2004-B10	5.25%	-	3,935,139	36,982	-	3,898,157	29,522
Single Family 2005							
Series 2005A	Variable	23,920,000	-	-	-	23,920,000	160,000
Series 2005B	Variable	-	20,000,000	-	-	20,000,000	-
Single Family 2006							
Series 2006A	Variable	-	23,809,000	22	-	23,808,978	67,871
Series 2006B	Variable	-	23,640,000	-	-	23,640,000	34,225
Total Principal		$ 80,074,211	$74,719,733	$ 19,789,378	-	$ 135,004,566	$ 601,216
Unamortized Premium		3,030,990				6,493,027	
		$ 83,105,201				$ 141,497,593	

NOTE 11: BONDED INDEBTEDNESS - Continued

The current portion of bonds payable at August 31, 2006 is $601,216; the remaining balance of $140,896,377 is classified as noncurrent bonds payable.

The principal and interest expense requirements for the next five years and beyond are summarized below:

Year Ended August 31	Principal	Interest	Total
2007	601,216	5,257,193	5,858,409
2008	1,600,638	7,235,621	8,836,259
2009	1,841,939	7,150,067	8,992,006
2010	1,944,134	7,055,994	9,000,128
2011	2,055,877	6,968,488	9,024,365
2012 thru 2016	12,200,870	33,025,571	45,226,441
2017 thru 2021	15,790,019	29,368,509	45,158,528
2022 thru 2026	21,301,346	24,411,755	45,713,101
2027 thru 2031	29,581,807	17,602,169	47,183,976
2032 thru 2036	35,359,215	8,278,345	43,637,560
2037 thru 2041	12,727,505	1,210,777	13,938,282
Total	$ 135,004,566	$ 147,564,489	$ 282,569,055

NOTE 12: SINGLE FAMILY BOND GRANT EXPENSE

Under the various Single Family Home Loan Programs provided by the Corporation first-time homebuyers are able to apply for a 30 year fixed rate mortgage loan which offers down payment assistance in the form of a grant. Grants are made in amounts equal to approximately 5% of the home purchase price. For fiscal year 2006, grant expense was $2,469,335.

NOTE 13: RELATED PARTY TRANSACTIONS

During the year the Corporation repaid a promissory note to the Department in the amount of $500,000 with zero interest. (See Note 10.)

On April 1, 2006, the Corporation entered into an agreement to act as Asset Oversight Agent for each of the Department's multifamily bond properties. Per

NOTE 13: RELATED PARTY TRANSACTIONS – Continued

the agreement, asset oversight fees collected by the Department since January 1, 2006 were remitted to the Corporation. These fees totaling approximately $158,000 are included in Asset Oversight and Compliance Fees in the Statement of Revenues, Expenses and Changes in Net Assets. Per the agreement, the Corporation agreed to remit to the Department a $3 administration fee per $25 asset oversight fee collected, payable each January 15th for collections in the previous calendar year. Administrative fees totaling approximately $27,000 are included in Accounts Payable on the Statement of Net Assets.

NOTE 14: EMPLOYEE BENEFITS

The Corporation is a co-employer with Administaff, a Professional Employer Organization (PEO) that serves as an off-site, payroll and human resources department. Administaff maintains the Corporation's employee benefits programs including a 401(k) retirement plan.

The 401(k) retirement plan is a defined contribution plan under which the Corporation matches dollar for dollar the first three percent (3%) and one half of the fourth and fifth percent of the employee's annual gross salary contributed to the plan. The maximum employer contribution is 4%. Total contributions for the year ended August 31, 2006, were approximately $65,000. Employee and employer contributions totaled approximately $47,000 and $18,000 respectively.

NOTE 15: COMMITMENTS AND CONTINGENCIES

In 2004, the Corporation partnered with Ameriquest to develop a mortgage financing program for eligible low-to-moderate income Texans that are not able to meet the traditional lending requirements. The Program rewards borrowers with lower interest rates and lower mortgage payments, for making timely mortgage payments. Through their combined efforts, Ameriquest and the Corporation will provide borrowers with an affordable mortgage loan product and down payment assistance equal to 5% of the mortgage loan amount. The Corporation has committed $1 million dollars for down payment assistance; Ameriquest has committed $100 million for mortgage loans.

NOTE 16: CONDUIT DEBT

The Corporation is authorized to issue statewide 501(c)(3) tax-exempt multifamily mortgage revenue bonds under the Texas Government Code §2306.555. The 501(c)(3) bond program provides long-term variable or fixed rate financing to non-profit borrowers/developers of new or existing multifamily rental properties in order to generate and/or preserve affordable rental housing. The Corporation may finance single developments or pools of properties located throughout the State of Texas. Borrowers must agree to set aside a prescribed percentage of a property's units for rent to persons and families of low income.

Under the Multifamily Private Activity Bond ("PAB") Program, the Corporation administers 10 percent or approximately $40 million of the State's volume cap allocation of private activity bonds for multifamily residential rental housing each year.

The 501(c)(3) and private activity revenue bonds are secured by the property financed and are payable solely from payments received on the underlying mortgage loans. Neither the Corporation, the State, nor any political subdivision thereof is obligated in any manner for repayment of the bonds. Accordingly, the bonds are not reported as liabilities in the accompanying financial statements.

As of August 31, 2006, there were twenty-two series of multifamily housing revenue bonds outstanding with an aggregate principal amount payable of approximately $380 million.

NOTE 17: RISK FINANCING AND RELATED INSURANCE ISSUES

The Corporation is exposed to various risks of loss related to torts, theft of, damage to, and destruction of assets, errors and omissions, and natural disasters. For all such risks the Corporation has purchased commercial insurance in varying amounts to mitigate the risk of loss.

NOTE 18: SUBSEQUENT EVENTS

In September 2006, the promissory note receivable related to the Town Oaks Apartments was paid in full. The Corporation received principal and accrued interest in the amounts of $145,120 and $4,484 respectively.

NOTE 18: SUBSEQUENT EVENTS - Continued

On October 1, 2006, the Corporation issued $23,650,000 in single family mortgage revenue bonds (Series 2006C). The bonds have an interest rate of 5.3%.

NOTE 19: CONTINUANCE SUBJECT TO REVIEW

Under the Texas Sunset Act, the Corporation will be abolished effective September 1, 2009 unless continued in existence as provided by the Act. If abolished, the Corporation may continue until September 1, 2010 to close out its operations.

NOTE 20: SEGMENT INFORMATION

For a description of the Corporation's operations, please see Note 1.

Segment financial information of the Corporation's only proprietary fund type at August 31, 2006 and for the year then ended is as follows:

Summary Financial Information	Amount
Operating Revenue	$ 6,122,692
Depreciation and Amortization	294,032
Net Loss	(3,158,946)
Net Working Capital*	58,229,258
Total Assets	153,241,670
Total Net Assets	6,311,108
Noncurrent Notes Payable	2,070,201
Noncurrent Bonds Payable	140,896,377
Deferred Revenue	1,383,308
Multifamily Custodial & Reserve Accounts	170,069
Fixed Asset Additions	17,503

NOTE 20: SEGMENT INFORMATION - Continued

* **Net Working Capital Calculation**		**Amount**
Unrestricted Cash and Cash Equivalents	$	1,002,356
Restricted Assets Held by Bond Trustee		53,823,044
Investments		4,940,483
Accounts Receivable & Accrued Revenue		558,039
Accrued Interest Receivable		37,252
Loans Receivable, Current Portion		92,743
Notes Receivable, Current Portion		161,567
Prepaid Expenses		24,381
Payables:		
Accounts & Accrued Expenses		(65,753)
Current Portion of Notes		(14,072)
Other Current Liabilities		(24,745)
Current Portion of Bonds & Accrued Interest		(2,306,037)
	$	58,229,258

SUPPLEMENTAL INFORMATION

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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FIANACIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Board of Directors
Texas State Affordable Housing Corporation
Austin, Texas

We have audited the financial statements of the Texas State Affordable Housing Corporation as of and for the year ended August 31, 2006, and have issued our report thereon dated November 28, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting
In planning and performing our audit, we considered the Texas State Affordable Housing Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted one item related to internal control over financial reporting that we have reported to management of Texas State Affordable Housing Corporation in a separate letter dated November 28, 2006.

Compliance and Other Matters
As part of obtaining reasonable assurance about whether the Texas State Affordable Housing Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, including the Public Funds Investment Act (Chapter 2256, *Texas Government Code*), regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported *under Government Auditing Standards*. However, we noted certain matters that we have reported to management of the Texas State Affordable Housing Corporation in a separate letter dated November 28, 2006.

This report is intended solely for the information and use of the audit committee, management, the Board of Directors and is not intended to be and should not be used by anyone other than these specified parties.

Mikeska Monahan + Peckham, LLP

Austin, Texas
November 28, 2006

TEXAS STATE AFFORDABLE HOUSING CORPORATION
SCHEDULE OF FINDINGS AND RESPONSES
YEAR ENDED AUGUST 31, 2006

A. SUMMARY OF AUDIT RESULTS

Financial Statements

Type of auditor's report issued:	Unqualified
Internal control over financial reporting:	
• Material weaknesses identified?	No
• Reportable conditions identified not Considered to be a material weakness?	None Reported
Noncompliance material to the financial statements noted?	No

B. Financial Statement Findings

None.

TEXAS STATE AFFORDABLE HOUSING CORPORATION
SCHEDULE OF PRIOR YEAR FINDINGS AND CORRECTIVE ACTION PLAN
YEAR ENDED AUGUST 31, 2006

A. PRIOR YEAR FINDINGS – FINANCIAL STATEMENTS AUDIT

None.

B. PRIOR YEAR FINDINGS AND QUESTIONED COSTS – MAJOR FEDERAL AWARD PROGRAMS AUDIT

None