2003-2004

Baylor University Annual Report

Fiscal year 2003-2004 was a period of extremes for Baylor University, a year of challenge and tremendous celebration. More than anything, the year's events reaffirmed Baylor's calling as a Christian institution of higher education.

Facing a limited national economic recovery, Baylor overcame the demands of a challenging fiscal year. The University emerged with a stronger endowment, healthy balance sheet, and positioned to meet the demands of fiscal year 2004-2005.

It was a season of farewells and a time of welcome. Baylor mourned the passing of a promising athlete-scholar, a much-admired Master Teacher, and the legendary "Voice of the Baylor Bears." During the same year, the University witnessed two of its sprinters well on their way to winning spots on the U.S. Olympic team, a Pulitzer Prize-nominated scholar-teacher join the Baylor faculty, and a revitalized athletic program gain encouraging ground.

Baylor made tremendous steps to meet the priorities of its Vision: academically, as evidenced by top national academic rankings propelled by programs that stretch students intellectually while supporting their deepest aspirations; physically, with the completion of facilities that enhance and integrate academic and community life; environmentally, with campus improvements that invite participation or encourage quiet reflection; and in athletics, with the Baylor men's tennis team bringing home the University's first-ever NCAA national team title.

Throughout its history, Baylor has been blessed with loyal and stalwart friends. This was especially apparent in September 2003 when, after a painful and tragic summer, beloved comedian Bill Cosby lifted spirits and Baylor pride at a free Student Spirit Rally staged at his request. During the rally he encouraged Baylor to continue doing what the University does best, which is to educate students.

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Live in Central Texas for any amount of time and one soon learns that storms are inevitable, impartial and can strike at any time. Resilience to storms is often tested on a human level as well and, just as in nature, ultimately will reveal the quality of one's foundation.

Baylor University was certainly challenged by storms during fiscal year 2003-2004.

No one could have predicted the extraordinary events of last summer or the resulting consequences. We were stunned and saddened at the tragic loss of athlete-scholar Patrick Dennehy, the painful revelation of NCAA violations, and the subsequent resignations of key athletic personnel. Pressures arising from economic recession, an unpredictable stock market and a lower-than-expected fall 2003 enrollment called for faculty and staff to streamline operational costs without compromising the quality of services for which Baylor is known.

Throughout our stormy season, the University family pulled together and effectively weathered each crisis as a community, strengthened and supported by our shared, foundational mission of educating students in the intellectual, moral and Christian choices essential to leading a meaningful life. More than 1-million square feet of major building projects were substantially completed this year, on time and under budget. And our athletic program is experiencing renewed vigor and restored confidence under new administrative and coaching leadership.

Building upon the foundation of our historical strengths are the core convictions and imperatives pursuant to the University's Vision and action plan that is boldly moving Baylor into the upper echelons of higher education, cemented in its commitment to Christ. As we have prepared the foundation to fulfill the Vision for Baylor, I've come to understand more than ever that it is not just the destination, but the journey that counts.

Journeys of true significance involve maps riddled with untraveled roads, where unforeseen detours can be expected, but they also lead to interesting encounters of personal discovery, surprising enlightenment and unparalleled growth. Transformational journeys will always test you; however, such journeys are the only path toward great rewards.

Fiscal year 2003-2004 was indeed a period of testing for our University, but more often it was a season of profound blessings. As you will discover in these pages, there is much good news to report.

Baylor University stands strong fiscally, secure in its Christian identity, and committed to an academic mission of providing students with an outstanding education in a faith-affirming environment. The Vision is being realized, with progress that is invigorating, tangible and continuing.

I can say with confidence that the University's future has never seemed more hopeful, or looked more exciting.

Robert B. Sloan, Jr.
President, Baylor University

Resilience to storms is often tested on a human level as well and, just as in nature, ultimately will reveal the quality of one's foundation.

During fiscal year 2003-04, Baylor University entered the second year of Baylor 2012, our long-range vision for the University. The University continued to provide financial aid to our student body at unprecedented levels, hired world-class faculty, and entered the final months of a comprehensive construction plan. The national economic effects of the 9/11 attacks and the subsequent war in Afghanistan and Iraq dampened our financial projections and required adjusting budgets to account for the realities. A reduced enrollment created additional challenges. The recent upturn in the equity markets and the long expected turnaround in the nation's economy portends a quick rebound.

During 2003-04, the total assets of the University increased from $1.231 billion to $1.363 billion. Baylor's net assets increased $139 million during the fiscal year to $990 million. Approximately $36 million of gifts and private grants, together with a rejuvenated financial market, resulted in an increase in total endowment from $557 million at May 31, 2003, to $672 million at May 31, 2004.

Fiscal year 2003-04 was the second year of transition to a flat-rate tuition plan that was intended to fund elements of Baylor's vision and align the institution's pricing system with its peer universities. The fall class of 2,678 freshmen and 420 transfers, participating in the new tuition structure, helped to generate total tuition and fees for the year of $229 million, an increase of $23.5 million over the prior year. Total revenues, net of scholarships, were $313 million for 2003-04, up $7 million from 2002-03.

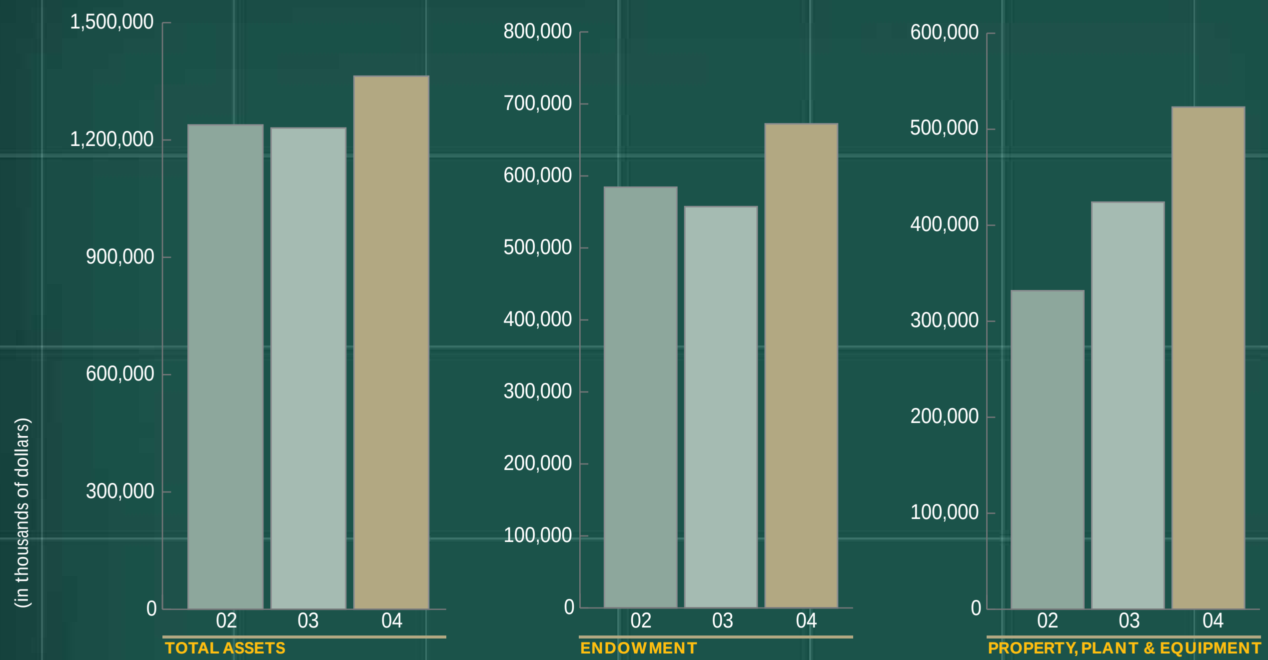
With the reduced enrollment impacting tuition and fees and the economy affecting other revenues, the University's 2003-04 operating budget had to be adjusted downward. To operate within a balanced budget, the University implemented a hiring freeze; cut operating expenses, capital expenditures, and transfers for major maintenance and renovation projects; and utilized quasi-endowment savings.

The University's balance sheet remained strong with total investments of $765 million at fiscal year end. Baylor's net investment in property, plant and equipment totaled $523 million at May 31, 2004, as compared to $424 million at May 31, 2003. During 2003-04 the University's long-term debt dropped $4.8 million to $256 million, and total liabilities also decreased to $373 million.

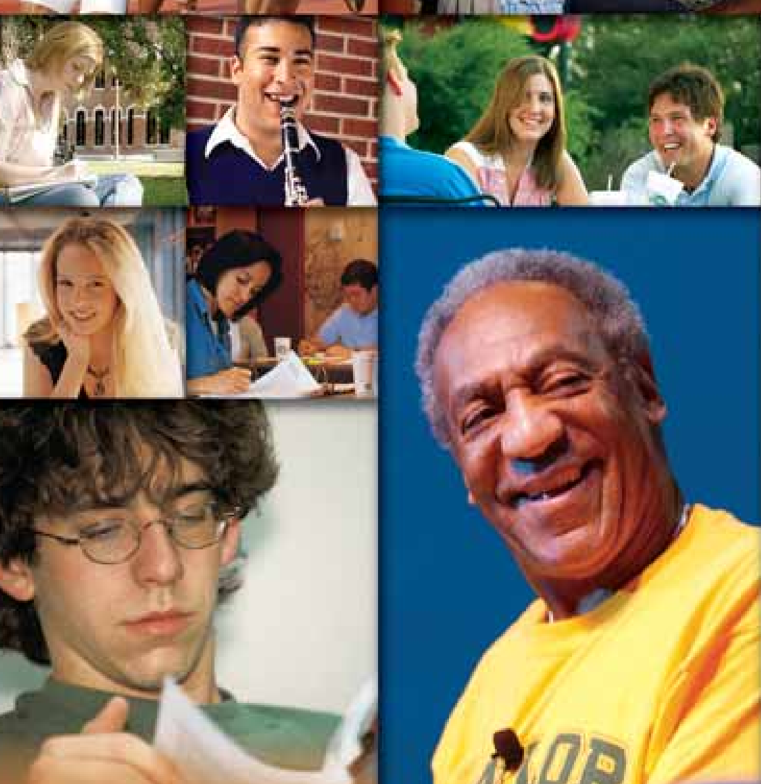
Construction was completed on the $23 million Harry and Anna Jeanes Discovery Center within the Mayborn Museum Complex and the $15 million Dutton Avenue Office and Parking Facility during 2003-04. As part of Baylor's Vision, the University also approached completion of the $103 million Baylor Sciences Building, the $33 million North Village Residential Community, and the $10 million East Campus Parking Facility. Both the Sciences Building and the North Village Residential Community will be open for the start of classes in fall 2004.

As we progress toward making Baylor University stronger, we continue to take a proactive approach while maintaining conservative financial principles that will allow for the accomplishment of the Baylor Vision and prepare the University to accomplish the vision and dreams of those who come after us. It takes the contributions of our students, alumni, faculty, staff and donors to continue moving Baylor University forward. My deepest appreciation to all those who continue to do their part to make Baylor great.

Reagan Ramsower
Acting Vice President for Finance and Administration



More than 1-million square feet...



ACADEMIC AND STUDENT LIFE

Baylor University is a vibrant intellectual campus fueled by robust programs and scholarly opportunities that excite the minds of students and faculty. It is a palpable energy upon which Baylor is building its academic reputation and, at the same time, gaining notice as a highly competitive academic institution, affirmed in the Christian tradition.

National educational rankings confirm that the Baylor Vision is succeeding in shaping and directing the University's educational mission in undergraduate, professional and graduate programs. Among Ivy League, Big Ten and Big 12 schools, Baylor was the only university to score an 'A' for providing students with a solid general education by the American Council of Trustees and Alumni. According to the *Princeton Review*, which listed the University in its annual college guide, *Best 351 Colleges*, Baylor is one of the country's best colleges for undergraduate education. *U.S. News & World Report* ranked Baylor's professional programs in law, business, engineering and nursing among the best in the nation this past year.

The student to faculty ratio at Baylor dropped to 16:1 in fall 2003 from 18:1 two years earlier. The lower ratio supports Baylor's imperative to increase interaction between professors and students by providing greater accessibility. Baylor intends to lower the ratio to 13:1 by 2012.

For the third year in a row, a Baylor University student was selected for the prestigious Truman Scholarship. Kristin Kan was one of 77 students representing 68 colleges and universities selected on the basis of leadership potential, intellectual ability, and likelihood of making a positive difference.

Baylor academic programs continue to earn high marks in distinction and generated greater visibility to the University in 2003-2004. One such program, the creation of living-learning centers, is new to Baylor, while another, the School of Music, is entering its second century of excellence.

During the fiscal year, Baylor moved forward with living-learning centers (LLC) by accepting student applications for review and naming faculty-in-residence. LLCs represent an exciting concept in higher education, one designed to foster a balance between serious intellectual pursuits and social interaction in the classroom and living room. Across the nation, research indicates that students who have greater interaction with faculty and who are able to pursue with peers their academic interests inside and outside of the classroom benefit from a greater college experience.

...opportunities to accomplish academic goals and,

Baylor announced plans for its first such center, the Engineering and Computer Science LLC (ECS LLC), in January 2003 as part of the North Village Residential Community, the first on-campus housing constructed in almost 40 years. The Honors College LLC, limited to students within the college's four programs, was announced in September 2003. Both are set to begin with the fall 2004 class.

LLC residents will live in a supportive community, within an intense academic program. As such, students must apply and be admitted to a specific LLC. The arrangement provides students with mentoring opportunities, easy accessibility to residential faculty, discussion groups and lab support so that individual capabilities can be fully actualized. Dr. Walter Bradley, Distinguished Professor of Engineering and associate dean of research in the School of Engineering and Computer Science, was selected as the first Faculty-in-Residence member, meaning he and his wife will reside in the ECS-LLCs.

As a prelude to celebrating 100 years of conferring degrees in May 2004, the School of Music collaborated with KWBU, Baylor's PBS- and NPR-affiliate stations, to produce *Christmas at Baylor.* This holiday special featured performances by the School's students and faculty and aired in December 2003 on PBS to a national audience. PBS has contracted to telecast the program again in 2004 and 2005. Another highpoint of the celebration year for the School of Music was the *Collage: Degrees of Excellence* event, a broad-context showcase of the School's achievements.

The Armstrong Browning Library this year purchased a substantial collection of English literature to add to its world-famous literary holdings, further enhancing its growing reputation as a specialist library of Victorian studies. Included in the newest collection is a prized, 1896 William Morris' Kelmscott Press edition of *The Works of Geoffrey Chaucer.*

Students benefited from a distinguished roster of visiting guests and renowned scholars during the 2003-2004 academic year. A three-judge panel of the United States Court of Appeals for the Fifth Circuit visited Baylor Law School in April 2004 to hear oral arguments in 16 cases, representing a remarkable opportunity for students to observe appellate lawyers and judges at work.

Legendary Texas playwright Horton Foote was honored at the inaugural Horton Foote American Playwrights Festival in March 2004. Sponsored by the department of theater arts, the festival included appearances by actors Robert Duvall, Estelle Parsons and Ellen Burstyn. Plans call for the Horton Foote American Playwrights Festival to annually celebrate a great American playwright with performances, an academic symposium on the writer and an award in Mr. Foote's name.

Visitors to Baylor campus included Dr. Bill Cosby, comedian, educator and humanitarian, who received an honorary doctorate of humane letters from the University during his September 2003 visit to campus. Other distinguished visitors included Pulitzer Prize-winning author David McCullough, who penned the bestselling biographies *Truman* and *John Adams*; Sen. Bill Brock, former U.S. trade representative and co-chair of the U.S.-Canada Partnership for Growth; Nobel Peace Prize winners Mairead Corrigan-Maguire, winner of the 1976 prize for her efforts to bring peace to her homeland of Northern Ireland, and renowned chemist Robert F. Curl Jr.; the Rev. Dr. John Polkinghorne, world-class mathematical physicist and former president of Queens' College in Cambridge, England; and American composer Libby Larsen, one of the country's most prolific living composers.

Central to the Baylor Vision is the core conviction of equipping individuals to understand life as a divine calling and thus serve society and the world. When two sophomore business majors, Chad Anderson and Drew Mitchell, announced and then began a quest to bicycle across the United States to benefit Big Brothers Big Sisters of Central Texas, their journey was an inspiring demonstration of faith in action. (The 3,700-mile journey, named Bike America 2K4, took the pair from California to Virginia and raised more than $7,000 when it was completed in summer 2004.)

Baylor takes its mission as a Christian intellectual community seriously and, therefore, seeks to foster an intellectual and thoughtful faith. Chapel Fridays were introduced in fall 2003 to have students meet in a small-group settings and process information presented by Chapel speakers earlier that week. More than 140 faculty and staff volunteered to serve as discussion group leaders for Chapel Fridays, which meets the first six weeks of each semester and is an excellent venue for new students to meet, explore their faith and foster lasting relationships.

The Baylor Vision brings the mission of the University to life: to be a world-class academic institution built on Christian faith for each generation of students, providing them with opportunities to accomplish academic goals and, at the same time, inspiring them to be lifelong stewards of their faith.

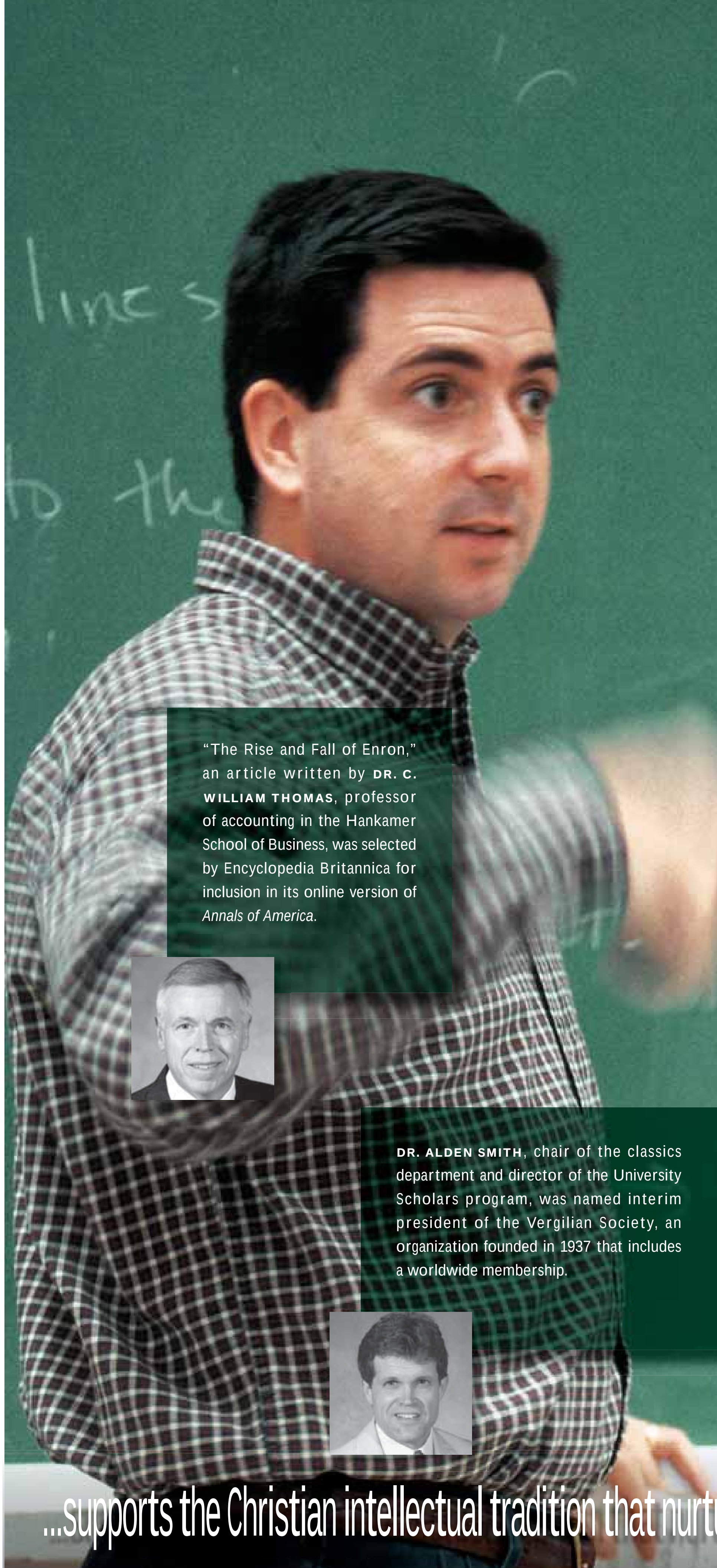
at the same time, inspiring them to be lifelong stewards of their faith.

FACULTY HIGHLIGHTS

The Baylor Vision has proven to be a strong recruitment tool in attracting teacher-scholars of extraordinary scholarship and international renown. The University added 23 faculty positions in the fall 2003 semester, filled by outstanding academes with credentials, awards, or experience from institutions such as Princeton, Harvard, Yale, Chicago, Cambridge, Oxford, and MIT. Each supports the Christian intellectual tradition that nurtures individual talent and, at the same time, fosters a desire to contribute in service to the world.

One example of the extraordinary caliber of teacher-scholar joining Baylor's faculty is Dr. Rodney Stark, Baylor's first University Professor of Social Sciences, a new position added this year. Long recognized as a preeminent academician in sociology of religion, Dr. Stark came to Baylor from Berkeley and is the author of 23 books, including *The Rise of Christianity: A Sociologist Reconsiders History*, which was nominated for the Pulitzer Prize in 1996.

Baylor is succeeding in developing a world-class faculty who daily reaffirm the integration of faith and learning, not just within appropriate disciplines, but in all interdisciplinary pursuits and collaborative activities. For example, 20 Baylor faculty traveled in December 2003 to Dohuk University in Northern Iraq on a mission to help rebuild the country's higher education system, representing the largest academic contingent to date from a U.S. university to go into Iraq. As "ambassadors of education," these Baylor professors were determining possible humanitarian and educational contributions for Iraq's reconstruction efforts.



"The Rise and Fall of Enron," an article written by **DR. C. WILLIAM THOMAS**, professor of accounting in the Hankamer School of Business, was selected by Encyclopedia Britannica for inclusion in its online version of *Annals of America*.

DR. ALDEN SMITH, chair of the classics department and director of the University Scholars program, was named interim president of the Vergilian Society, an organization founded in 1937 that includes a worldwide membership.

The United States Justice Department selected the Robert Wood Foundation's Nurse-Family Partnership (NFP) for nation-wide implementation in conjunction with its federal Weed and Seed grant program. **DR. CAROLE HANKS**, associate professor at the Louise Herrington School of Nursing, serves as co-investigator for the research program, which incorporates community-based initiatives to reduce crime and revitalize low-income neighborhoods.

DR. DAVID L. JEFFREY, provost and Distinguished Professor of Literature and Humanities, joined the ranks of distinguished scholars, Pulitzer and Nobel Prize winners and acclaimed writers who have received the Lifetime Achievement Award from the Conference on Christianity and Literature.

Several Baylor faculty were named Fellows in their respective fields this year, including **DR. MICHAEL KORPI**, professor and chair of the Department of Communication Studies, who was named a Senior Research Fellow with the prestigious IC2 Institute at the University of Texas. **DR. DAVID RUDD**, professor of psychology and neuroscience and director of the doctoral program in clinical psychology, was named a Fellow by the American Psychology Association and **DR. JUDY WRIGHT LOTT**, professor and dean of the Louise Herrington School of Nursing, was named a Fellow by the American Academy of Nursing.

DR. MARTIN MEDHURST, Distinguished Professor of Rhetoric and Communication, was awarded Ohio University's Boase Prize for Scholarship.

DR. DAVID GARLAND, associate dean and professor of Christian scriptures at George W. Truett Theological Seminary, and **DR. RODNEY STARK**, University Professor of Social Sciences, were presented an Award of Merit by the internationally renowned *Christianity Today* magazine.

Tech Briefs, a NASA magazine reporting innovative engineering design and manufacturing solutions, recognized **DR. ROBERT J. MARKS**, Distinguished Professor of Engineering, for innovations reported in his paper, "Minimum Power Broadcast Trees for Wireless Networks."

DR. LIANNE FRIDRIKSSON, associate professor and director of graduate studies in the journalism department, received a Fulbright Scholar grant, the third time she has received the prestigious award.

ures individual talent and, at the same time, fosters a desire to contribute in service to the world.

FACILITIES

The most casual observer this year could see the Baylor Vision in action, simply by watching the evolving Baylor landscape. Several key residential, academic and community facilities were completed, or substantially completed, over the course of 2003-2004, bringing the most ambitious major capital projects campaign in Baylor's history to near conclusion.

As the University draws ever closer to fulfilling the imperative of creating a fully engaged, daily living and learning environment, it is being accomplished in a manner continuous with an honored past. For it was Baylor's founders, including William Tryon, James Huckins, and R.E.B. Baylor, who first envisioned a university that would be "fully susceptible of enlargement and development to meet the needs of all ages to come."

More than a century-and-a half later, their historic vision continues to take shape in the form of bricks and mortar, as evidenced by the following list of Baylor's most recent structural achievements:

• The North Village Residential Community will be the home this fall to 600 students, including the Engineering and Computer Science Living-Learning Community of 180 students. The facility features a variety of room plans, a cafe, sport courts, a community lounge, a spiritual walkway and quiet prayer gardens. So popular is the concept of a "village" on Baylor's campus that it holds a 300-student waiting list.

• Hundreds of well-wishers attended the May 2004 dedication of the Harry and Anna Jeanes Discovery Center, the exciting focal point of the Sue and Frank Mayborn Natural Science and Cultural History Museum. Designed to be enjoyed by the entire family, the 123,000-square-foot, state-of-the-art Mayborn Museum Complex delivers a wealth of experiential learning opportunities for visitors of all ages and is earning wide-spread acclaim for its quality exhibits.

• The $103 million Baylor Sciences Building is a 500,000-square-foot science education center that embodies the Vision by following a Christian tradition of loving God with our minds by studying His "two books:" the Bible and the natural World He created. The ultra-modern facility, the largest single construction project in Baylor's history, features three research wings and five multidisciplinary teaching labs to position Baylor competitively among the world's top-tier institutions. Faculty state that the building will create a new culture of science at Baylor, one that produces not just excellent scientists, doctors, nurses and teachers, but one that equips students as future world leaders in solving complex scientific challenges.

• The Dutton Avenue Office and Parking Facility is winning industry raves for excellence in design and construction. The $15 million facility was recognized in January 2004 by *Texas Construction* magazine with two awards: the Best of 2003 Award in the educational (college/university) category and the Best of 2003 Merit Award for Architectural Design. In addition to the *Texas Construction* award, Associated Builders and Contractors Inc. honored the Dutton Avenue facility with the North Texas Chapter 2003 Merit Award in its category. The four-level facility has met every expectation since its opening in August 2003, providing the Baylor campus with 1,200 parking spaces; office space to support information technology, academic and administrative departments; and restaurant/retail space, including the nation's first Chili's Too on a college campus and a full-service Starbucks.

• Construction began in summer 2003 on the $10 million East Campus Parking Facility, a 1,170-car garage that will support the Baylor Sciences Building and the McLane Student Life Center by providing much needed parking to students, faculty and visitors.

• In November 2003 four national architectural firms that specialize in college student center renovation projects submitted design proposals to Baylor for consideration on the upcoming renovation of the Bill Daniel Student Center. The firms met with faculty, staff, alumni and student focus groups before submitting their design recommendations.

• A lead gift received from the Bill and Eva Williams family of Scottsdale, Ariz., in spring 2004 moved the Bear Habitat expansion and renovation project halfway to its goal of $950,000. When completed, Baylor's most popular visiting site will be doubled in size and feature terraced landscaping and rockwork that more closely resembles the North American Black Bears' natural habitat. The enhanced facility will be named the Bill and Eva Williams Bear Habitat Complex and provide an enjoyable and valuable educational experience to area schoolchildren, students, alumni and campus visitors.

...it is being accomplished in a manner continuous with an honored past.

STRATEGIC PLANNING

Strategic Planning and Improvement was established in 2002-2003 to create and implement a simple and effective iterative planning, budgeting, implementation and evaluation approach to ensure that the University's actions are continually aligned with, and promote the achievement of, Baylor Vision imperatives.

During this fiscal year, focus has been on the creation of a University-wide, data-based portfolio management system called Project Portfolio Management (PPM). PPM continuously tracks and prioritizes a set of project-oriented initiatives determined to deliver maximum value to the University. The PPM approach provides crucial information and analysis in the development of appropriate operational strategies and subsequent action plans. PPM is a valuable tool to Baylor leadership in efficiently using financial and staff resources to focus on projects that are achievable and strategically aligned with Vision goals.

At May 31, 2004, the PPM approach had provided support in the following areas: student financial aid; University relations; purchasing; operations and facilities; University host; information management and testing services; financial services; student life and construction management.

The strategic planning staff began the implementation of an Organizational Assessment Plan this year to capture baseline data as it relates to the Baylor Vision. An Integrated Assessment Team, made up of departmental representatives throughout the University, has been established to foster the coordination and communication of all University assessment initiatives.

During 2003-2004 the capital project request process began using the Project Office strategic planning system. Implementation of the system began with the fiscal year 2005 budget requests. At May 31, 2004, 144 capital project requests had been entered, totaling a little more than $17 million in estimated costs. Executive Council members now have the convenience of a completely electronic process by which to review specific capital project requests.

2003-2004 FINANCIALS

Throughout the 2003-2004 budget year, Baylor's financial staff analyzed, evaluated and adjusted to the challenge of decreased resources while making progress in meeting Baylor Vision imperatives.

Continued budget management and more conservative enrollment projections, augmented by improving financial markets and interest rates, have well-positioned Baylor for fiscal success in the coming year.

BOND DEBT. Because Baylor engaged in its extensive building campaign during a recessionary, low-interest economic period, the University was able to obtain more advantageous pricing and interst rates than are typically available. Of the $247 million in bonds that have been issued, almost $50 million of that amount was a refinancing of existing debt. Only 4.7 percent of the University's 2003-2004 operating budget was expended for debt service.

TUITION AND FEES. The fall 2003 enrollment of 13,937 students, compared to 14,159 students enrolled the previous year, was lower than originally budgeted for the fiscal year and contributed to a $9.5 million reduction in the University's 2003-2004 operating budget. Still, income generated from tuition and fees for the fiscal year totaled $229 million, an increase of $23 million over the previous year, and comprised 74 percent of Baylor's total budget.

It would be a simple thing for Baylor to meet or exceed enrollment projection numbers if the University was willing to lower its academic entrance standards. As an aspiring top-tier institution, Baylor has been unwilling to compromise academic quality in exchange for student quantity. The result has been that the academic quality of entering freshmen has continued to rise. In fact, the SAT scores of entering freshmen have increased over the past six years by 40 points.

FUNDRAISING AND THE ENDOWMENT. Baylor's 10-year fundraising initiative, the Campaign for Greatness, received $45.5 million in gifts during calendar year 2003, which represented the fourth-largest amount ever given to the university during a calendar year. This figure does not include gifts made to the independent Baylor Alumni Association.

Of the 16,440 individuals, foundations, companies and organizations that committed their financial support, 3,500 were first-time donors. Such broad-based support is an encouraging indication of the passion that exists for Baylor's mission, and a demonstrated commitment to the components of the University's Vision. The gifts supported student scholarships, academic programs, athletics and construction projects pursuant to the Baylor Vision imperatives.

The Baylor endowment enjoyed a substantial gain in 2003-2004 when the stock market took a dramatic turn for the better beginning in spring 2003. The rebound in the equities market, augmented by targeted contributions and insightful investment policies and practices, resulted in a significant strengthening of Baylor's endowment. At May 31, 2004, the market value of Baylor's endowment stood at $672 million, an increase of $115 million over last year. The 21 percent increase was among the top endowment growth rates in the nation.

...fully susceptible of enlargement and development to meet the needs of all ages to come.

LOOKING TO THE FUTURE

As with the institution itself, a Baylor education transcends the classroom to include life in all its aspects, examined within a Christian intellectual context. Only in this way can students graduate prepared to embrace every opportunity and equipped to persevere as ambassadors for Christ amidst the pressures of a complex, unstable world.

The ability to collectively manage adversity and stay the course in fulfilling Vision imperatives characterizes fiscal year 2003-2004. The challenges continue, but the goal is in sight and Baylor University is moving forward, intent on success.

FINANCIAL STATEMENTS

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INDEPENDENT AUDITORS' REPORT

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BAYLOR UNIVERSITY

We have audited the accompanying balance sheets of Baylor University (the "University") as of May 31, 2004 and 2003, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the University'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 present fairly, in all material respects, the financial position of the University as of May 31, 2004 and 2003, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

DALLAS, TEXAS

AUGUST 25, 2004

MAY 31, 2004 AND 2003

(in thousands of dollars)

	MAY 31, 2004			
	UNRESTRICTED	TEMPORARILY RESTRICTED	PERMANENTLY RESTRICTED	TOTAL
ASSETS				
Cash & cash equivalents	$ 9,822	$ —	$ —	**$ 9,822**
Student accounts receivable, net	11,575	—	—	**11,575**
Contributions, grants & other receivables	18,649	7,641	6,473	**32,763**
Prepaid expenses & other	7,615	27	4	**7,646**
Student loans receivable, net	9,670	—	3,116	**12,786**
Investments, at fair value	268,795	53,726	442,878	**765,399**
Property, plant & equipment, net of accumulated depreciation of $197,718 and $214,851	523,098	—	—	**523,098**
TOTAL ASSETS	**$ 849,224**	**$ 61,394**	**$ 452,471**	**$ 1,363,089**
LIABILITIES & NET ASSETS				
LIABILITIES				
Accounts payable	$ 26,289	$ 365	$ 98	**$ 26,752**
Salaries & payroll taxes payable	23,629	—	—	**23,629**
Deposits & deferred income	28,430	120	—	**28,550**
Annuities payable	—	1,402	4,358	**5,760**
Notes & bonds payable	256,438	—	—	**256,438**
Liability for interest rate swap	24,790	—	—	**24,790**
Federal student loan funds refundable	7,254	—	—	**7,254**
TOTAL LIABILITIES	**366,830**	**1,887**	**4,456**	**373,173**
NET ASSETS				
Unrestricted	1,724	—	—	**1,724**
Designated for operations	17,907	—	—	**17,907**
Restricted	—	8,021	5,824	**13,845**
Annuity & living trusts	—	8,898	18,951	**27,849**
Endowment	111,442	31,973	423,240	**566,655**
Board designated endowment	100,041	5,645	—	**105,686**
Net invested in plant	251,280	4,970	—	**256,250**
TOTAL NET ASSETS	**482,394**	**59,507**	**448,015**	**989,916**
TOTAL LIABILITIES & NET ASSETS	**$ 849,224**	**$ 61,394**	**$ 452,471**	**$ 1,363,089**

See accompanying notes to financial statements.

MAY 31, 2003			
UNRESTRICTED	TEMPORARILY RESTRICTED	PERMANENTLY RESTRICTED	TOTAL
$ 7,057	$ 3	$ —	**$ 7,060**
4,099	—	—	**4,099**
17,439	7,556	5,960	**30,955**
7,734	7	4	**7,745**
9,952	—	1,641	**11,593**
282,118	43,514	419,404	**745,036**
424,063	—	—	**424,063**
$ 752,462	**$ 51,080**	**$ 427,009**	**$ 1,230,551**
$ 21,404	$ 667	$ 99	**$ 22,170**
19,582	—	—	**19,582**
20,586	121	—	**20,707**
—	1,686	5,561	**7,247**
261,209	—	—	**261,209**
41,711	—	—	**41,711**
7,190	—	—	**7,190**
371,682	**2,474**	**5,660**	**379,816**
2,608	—	—	**2,608**
15,632	—	—	**15,632**
—	8,043	5,643	**13,686**
—	7,228	16,428	**23,656**
46,078	19,833	399,278	**465,189**
87,694	4,459	—	**92,153**
228,768	9,043	—	**237,811**
380,780	**48,606**	**421,349**	**850,735**
$ 752,462	**$ 51,080**	**$ 427,009**	**$ 1,230,551**

FOR THE YEARS ENDED MAY 31, 2004 AND 2003

(in thousands of dollars)

	MAY 31, 2004			
	UNRESTRICTED	TEMPORARILY RESTRICTED	PERMANENTLY RESTRICTED	TOTAL
REVENUES				
Tuition & fees	$ 228,725	$ —	$ —	**$ 228,725**
Less scholarships	(59,433)	—	—	**(59,433)**
Net tuition & fees	169,292	—	—	**169,292**
Gifts, private grants & Baptist General Convention of Texas appropriation	12,468	6,347	16,907	**35,722**
Endowment & investment income	33,141	4,621	826	**38,588**
Realized gains (losses) on investments	4,272	(30)	1,362	**5,604**
Other sources	16,877	9,426	—	**26,303**
Auxiliary enterprises	37,960	—	—	**37,960**
TOTAL REVENUES	274,010	20,364	19,095	**313,469**
Net assets released from restrictions	24,360	(24,231)	(129)	—
TOTAL NET REVENUES	298,370	(3,867)	18,966	**313,469**
EXPENSES				
Program expenses				
Instruction	133,330			**133,330**
Academic support, research & public service	39,121			**39,121**
Student services	19,744			**19,744**
Auxiliary enterprises	50,653			**50,653**
Support expenses				
Institutional support	43,610			**43,610**
TOTAL EXPENSES	286,458			**286,458**
INCREASE (DECREASE) IN NET ASSETS BEFORE OTHER CHANGES	11,912	(3,867)	18,966	**27,011**
OTHER CHANGES				
Unrealized gains (losses) on investments	76,108	13,108	4,936	**94,152**
Unrealized gain (loss) on interest rate swap	16,921	—	—	**16,921**
Loss on disposal of fixed assets	(3,327)	—	—	**(3,327)**
Change in value of split interest agreements - Present value adjustments	—	1,660	2,764	**4,424**
TOTAL OTHER CHANGES	89,702	14,768	7,700	**112,170**
INCREASE (DECREASE) IN NET ASSETS	101,614	10,901	26,666	**139,181**
NET ASSETS AT BEGINNING OF YEAR	380,780	48,606	421,349	**850,735**
NET ASSETS AT END OF YEAR	**$ 482,394**	**$ 59,507**	**$ 448,015**	**$ 989,916**

See accompanying notes to financial statements.

MAY 31, 2003

UNRESTRICTED	TEMPORARILY RESTRICTED	PERMANENTLY RESTRICTED	TOTAL
$ 205,258	$ —	$ —	**$ 205,258**
(50,208)	—	—	**(50,208)**
155,050	—	—	**155,050**
14,699	8,150	20,999	**43,848**
30,079	4,326	192	**34,597**
127	366	8,967	**9,460**
17,991	8,119	—	**26,110**
37,358	—	—	**37,358**
255,304	20,961	30,158	**306,423**
24,317	(25,602)	1,285	**—**
279,621	(4,641)	31,443	**306,423**
124,092			**124,092**
36,720			**36,720**
19,831			**19,831**
48,681			**48,681**
42,004			**42,004**
271,328			**271,328**
8,293	(4,641)	31,443	**35,095**
(42,386)	(8,229)	(4,983)	**(55,598)**
(26,291)	—	—	**(26,291)**
(504)	—	—	**(504)**
—	(240)	(912)	**(1,152)**
(69,181)	(8,469)	(5,895)	**(83,545)**
(60,888)	(13,110)	25,548	**(48,450)**
441,668	61,716	395,801	**899,185**
$ 380,780	**$ 48,606**	**$ 421,349**	**$ 850,735**

FOR THE YEARS ENDED MAY 31, 2004 AND 2003

(in thousands of dollars)

	YEARS ENDED MAY 31, 2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
INCREASE (DECREASE) IN NET ASSETS	**$ 139,181**	**$ (48,450)**
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities:		
Depreciation	24,890	23,669
Loss on disposal of property & equipment	3,327	504
Fixed assets gifts-in-kind	(53)	(44)
Net realized & unrealized (gains) losses on investments	(99,756)	46,138
Contributions restricted for permanent investments	(13,768)	(20,999)
Unrealized (gain) loss on interest rate swap	(16,921)	26,291
Decrease (increase) in:		
Student accounts receivable	(7,375)	(2,589)
Contributions, grants & other receivables	(1,909)	(2,868)
Prepaid expenses & other	99	700
Increase (decrease) in:		
Accounts payable	4,582	11,812
Salaries & payroll taxes payable	4,047	3,262
Deposits & deferred income	7,843	788
Annuities payable	(1,487)	2,127
NET CASH PROVIDED BY OPERATING ACTIVITIES	**42,700**	**40,341**
CASH FLOWS FROM INVESTING ACTIVITIES		
Loans to students, net change	(1,193)	(460)
Proceeds from sales of investments	424,194	472,929
Purchases of investments	(344,801)	(419,529)
Proceeds from sale of property & equipment	2,312	—
Purchases of property, plant & equipment	(129,511)	(116,423)
NET CASH USED IN INVESTING ACTIVITIES	**(48,999)**	**(63,483)**
CASH FLOWS FROM FINANCING ACTIVITIES		
Contributions restricted for permanent investments:		
Endowment	13,055	18,537
Annuities & living trusts	713	2,462
Proceeds from long-term debt	2,370	542
Repayment of long-term debt	(7,141)	(4,312)
Increase in federal student loan funds refundable	64	92
NET CASH PROVIDED BY FINANCING ACTIVITIES	**9,061**	**17,321**
NET INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS	**2,762**	**(5,821)**
CASH & CASH EQUIVALENTS AT BEGINNING OF YEAR	**7,060**	**12,881**
CASH & CASH EQUIVALENTS AT END OF YEAR	**$ 9,822**	**$ 7,060**

See accompanying notes to financial statements.

MAY 31, 2004 AND 2003

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF ACCOUNTING & REPORTING

The financial statements of Baylor University (the "University") include the accounts of the University, Waco Arbors Holding Corporation and Brazos Valley Public Broadcasting Foundation (KWBU), legally separate entities, the board of directors of which are chosen by the University's Board of Regents. The University's financial statements do not include the accounts of the Baylor Foundation, Baylor Stadium Corporation, Baylor Bear Foundation, Baylor-Waco Foundation or Baylor Alumni Association. These entities are excluded due to the nature of their relationship to the University or due to their aggregate assets, revenues, expenses, and net assets not being significant in relation to the University.

The financial statements of the University are prepared on the accrual basis. The University's net assets and revenues, expenses, gains and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets and changes therein are classified as follows:

Unrestricted — net assets that are not subject to donor-imposed restrictions.

Temporarily restricted — net assets subject to donor-imposed or legal restrictions that may meet or will be met either by actions of the University and/or the passage of time.

Permanently restricted — net assets subject to donor-imposed restrictions that the assets be maintained permanently. Generally, the donors of these assets permit the University to use all or part of the income earned on the related investments for general or specific purposes.

Revenues are reported as increases in unrestricted net assets unless the use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Expirations of temporary restrictions on net assets are reported as net assets released from temporary restrictions among applicable net asset classes.

Income and realized net gains and losses on investments are reported as follows:

- As changes in permanently restricted net assets if so restricted by the donor;
- As changes in temporarily restricted net assets if the terms of the gift impose restrictions on the use of the income or gains and losses; and
- As changes in unrestricted net assets in all other cases.

FUND ACCOUNTING

To ensure observance of limitations and restrictions placed on the use of resources available to the University, the internal accounts are maintained in accordance with the principles of fund accounting. This is the procedure by which resources for various purposes are classified into funds that are in accordance with specified activities or objectives. These financial statements, however, are prepared to focus on the entity as a whole and to present transactions according to the existence or absence of donor-imposed restrictions.

FUNCTIONAL ALLOCATION OF EXPENSES

The expenses of providing various programs and support services have been categorized on a functional basis in the statements of activities. Accordingly, expenses such as depreciation and operation and maintenance of plant have been allocated directly or based on square footage among the functional categories.

Fundraising expenses of approximately $6,370,000 and $6,559,000 incurred by the University in 2004 and 2003, respectively, are included in the institutional support category in the statements of activities.

CONTRIBUTIONS

Contributions received with donor-imposed restrictions that are met in the same year as received are reported as revenues of the unrestricted net asset class.

Donor contributions to fund construction projects are classified as temporarily restricted net assets until the facility is placed in service. At that time, the temporarily restricted net assets are released from restriction and replenish unrestricted net asset balances designated for plant projects. The University follows the policy of recording contributions of long-lived assets directly as invested in plant assets instead of recognizing the gift over the useful life of the asset.

CASH EQUIVALENTS

Cash on deposit for operations and all highly liquid financial instruments with maturities of 90 days or less are classified as cash equivalents, except those amounts assigned to investment managers, which are classified as investments. The fair value of cash equivalents is estimated to be the same as book value due to the short maturity of these instruments.

ENDOWMENT

Endowment net assets classified as unrestricted include realized gains and losses and net unrealized appreciation (depreciation) on endowment assets the earnings of which are unrestricted by the donor. Endowment net assets classified as temporarily restricted include realized gains and losses and net unrealized appreciation (depreciation) on endowment assets that are restricted by the donor for a specific purpose. Permanently restricted endowment net assets are those assets that must be invested in perpetuity to provide a permanent source of income.

Board designated endowment net assets include gifts and funds that have been designated by the Board of Regents (the "Board") to function as endowment. These funds may be expended at the discretion of the Board. Also included are certain temporarily restricted net assets that have not been expended for their restricted purpose but are being invested and the earnings expended for the restricted purpose.

The Baylor University Fund ("BUF") is a unitized fund consisting of equities, fixed income and alternative assets and serves as the primary investment vehicle for the University's endowment and other long-term investments. The University has adopted a spending policy for the BUF whereby the Board authorizes a dividend be paid for endowments participating in the BUF for the purposes intended by the donors. This dividend was based on 5% of the previous 48 months' average market value per unit of the BUF for the years ended May 31, 2004 and 2003. If the current income of the BUF is not sufficient to cover the dividend amount, the amount needed is taken from the accumulated capital gains within the BUF.

SPLIT INTEREST AGREEMENTS

Split interest agreements consist primarily of gift annuities, charitable remainder unitrusts and annuity trusts, life income funds and perpetual trusts. Assets held under these agreements are included in investments (see Note 2), except for agreements administered by the Baptist Foundation of Texas ("BFT") and others as temporary trustees. The net present values of these agreements administered by the BFT and others as temporary trustees are reflected as unconditional promises to give (see Note 10). Annuities payable are recorded at the present value of future payments. For the year ended May 31, 2004, the method of calculating the present value was changed to use the Internal Revenue Service ("IRS") discount rate at the time of the original gift rather than the current IRS discount rate. For the year ended May 31, 2003, a discount rate of 3.8% was used.

STUDENT LOANS

The assets and liabilities of student loans financed primarily by the federal government and administered by the University, primarily the Federal Perkins Loan Program, are included with those of the University. The total of the federal government portion of these net assets is shown as federal student loan funds refundable in the accompanying balance sheets.

PROPERTY, PLANT & EQUIPMENT

Property, plant & equipment valued at $5,000 or more are recorded at cost at date of acquisition or, if acquired by gift, at estimated fair value at date of gift. Additions to plant assets are capitalized, while maintenance and minor renovations are charged to operations. Plant assets are reflected net of accumulated depreciation calculated on a straight-line basis over the estimated useful lives ranging from 3 to 50 years.

DEPOSITS & DEFERRED INCOME

Deposits & deferred income consist of amounts billed or received for educational, research and auxiliary goods and services that have not yet been earned.

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 amounts reported in the statements and accompanying notes. Actual results could differ from those estimates.

OTHER

Certain reclassifications have been made to the 2003 finacial statements to conform to the 2004 presentation.

2. INVESTMENTS

The University's investments are recorded at fair value. Cost and estimated fair value of financial instruments as of May 31, 2004 and 2003 are as follows:

(in thousands of dollars)

	2004		2003	
	Cost	Estimated Fair Value	Cost	Estimated Fair Value
Investments:				
Short-term	$ 30,422	$ 32,091	$ 27,173	$ 29,185
Collateralized investment contract	29,808	29,808	133,777	133,777
Debt securities	70,721	87,244	75,936	84,866
Equity securities	371,946	470,638	373,859	408,511
Alternative assets	82,401	104,884	50,641	54,982
Real estate	13,349	20,292	14,234	18,300
Mineral rights	12,395	20,064	11,901	15,145
Other	376	378	270	270
TOTAL INVESTMENTS	$ 611,418	$ 765,399	$ 687,791	$ 745,036

Net appreciation (depreciation) in the fair value of investments, which consists of the realized gains and losses and the unrealized appreciation (depreciation) on those investments, is shown in the statements of activities.

Short-term investments consist primarily of short-term U.S. Government securities and money market funds and are not subject to significant market or credit risks. The collateralized investment contract is with Trinity Plus Funding Company, LLC and pays interest at a rate tied to the Bond Market Association Municipal Swap Index. Alternative assets consist of distressed securities, venture capital, hedge funds and private equities.

The fair value of real estate is determined from the most recent information available to the University (i.e. appraisals and/or property tax statements). The fair value of mineral rights is estimated based on the income stream generated by those assests.

Investments, at fair value, are managed by the following:

(in thousands of dollars)

	2004	2003
The University	$ 607,212	$ 602,029
BFT	125,197	111,155
Others	32,990	31,852
TOTAL	$ 765,399	$ 745,036

The BFT is an agency of the Baptist General Convention of Texas that was created to manage investment funds for Texas Baptist institutions. The investments managed by the BFT for the University represent approximately 9% of the BFT's total assets as of May 31, 2004 and 2003.

Investments include interests in split interest agreements. The fair values representing interests in split interest agreements are $129,000,000 and $117,866,000 as of May 31, 2004 and 2003, respectively.

Investment return for the years ended May 31, 2004 and 2003 consists of the following:

(in thousands of dollars)

	2004	2003
Endowment & investment income	$ 38,588	$ 34,597
Realized gains on investments	5,604	9,460
Unrealized gains (losses) on investments	94,152	(55,598)
TOTAL INVESTMENT RETURN	$ 138,344	$ (11,541)

The endowment & investment income reflected is net of investment expenses of $5,024,000 and $3,771,000 for the years ended May 31, 2004 and 2003, respectively.

3. PROPERTY, PLANT & EQUIPMENT

At May 31, 2004 and 2003, plant assets consist of:

(in thousands of dollars)

	2004	2003
Land	$ 28,218	$ 27,913
Buildings	379,950	347,196
Equipment	79,434	107,612
Other improvements	73,042	65,247
	560,644	547,968
Less accumulated depreciation	(197,718)	(214,851)
	362,926	333,117
Construction-in-progress	160,172	90,946
PROPERTY, PLANT & EQUIPMENT, NET	$ 523,098	$ 424,063

Depreciation expense was $24,890,000 and $23,669,000 as of May 31, 2004 and 2003, respectively. Real and personal property were insured at $800,000,000 and $600,000,000 at May 31, 2004 and 2003 respectively. During the current fiscal year, the University increased its capitalization minimum from $2,000 to $5,000 per item. With this change, the University wrote off minor equipment (equipment fully depreciated with a value under $5,000), as well as buildings, land improvements and equipment resulting from sales, demolitions, or other disposals. These actions resulted in a write-off of $47,424,000 ($36,957,000 related to the write-off of fully depreciated equipment) and the accompanying depreciation of $41,520,000 ($36,957,000 related to the write-off of fully depreciated equipment).

4. NOTES & BONDS PAYABLE

Notes & bonds payable consisting of both non-interest bearing unsecured notes and interest bearing unsecured and secured notes and bonds with varying terms and maturity dates to February 1, 2032 were $256,438,000 and $261,209,000 at May 31, 2004 and 2003, respectively. Interest payments on a cash basis totaled $9,212,000 and $7,467,000 and interest expense was $10,466,000 and $10,133,000 for the years ended May 31, 2004 and 2003, respectively. Interest expense totaling $8,686,000 and $6,503,000 was capitalized to projects for the years ended May 31, 2004 and 2003, respectively. Earnings on bond proceeds, which offset interest capitalized, were $1,052,000 and $2,092,000 for the years ended May 31, 2004 and 2003, respectively.

The University issued $247,500,000 in tax exempt and taxable revenue bonds through the Waco Education Finance Corporation during the fiscal year ended May 31, 2002 of which $47,059,000 was used to refinance Series 1997, 1998, 1999, 2000 and 2001 bonds. The University capitalized and is amortizing on a straight-line basis bond issue costs related to the Series 2002A, 2002B and 2002C issues over the life of the bonds. As of May 31, 2004 and 2003, unamortized bond issue costs of $3,803,000 and $3,938,000, respectively, are included in prepaid expenses and other in the University's balance sheets. Amortization expense for issue costs was $163,000 and $151,000 for the years ended May 31, 2004 and 2003, respectively.

Notes and bonds payable at May 31, 2004 and 2003 consist of the following:

(in thousands of dollars)

	2004	2003
Non-interest bearing unsecured note payable to a foundation, due in annual installments beginning June 30, 2004	$ 5,000	$ 4,958
Non-interest bearing unsecured note payable to a foundation, due in quarterly installments as repayments from loans to students are received.	2,230	2,650
Unsecured note payable to a foundation, bearing interest at 5%, due in annual installments to May 15, 2006, interest only May 15, 2003	2,000	3,000
Non-interest bearing unsecured notes payable to a corporation, due in monthly installments through September 1, 2008	1,084	1,334
Secured note payable to a private entity (secured by land), bearing interest at 7.5%, due in annual installments of $747,314 to January 1, 2012	4,377	4,767
Non-interest bearing unsecured note payable to a private entity, due in annual installments through June 30, 2008	350	—
Secured note payable to a private entity (secured by property), bearing interest at 9.57%, due in monthly installments through July 1, 2006 then due in full August 1, 2006	1,897	—
Series 2002A Waco Education Finance Corporation Tax-Exempt Variable Rate Demand Bonds swapped to a fixed rate of 4.91% (see Note 5), interest payable semiannually, principal payable annually to February 1, 2032	171,900	174,075
Series 2002B Waco Education Finance Corporation Tax-Exempt Select Auction Variable Rate Securities ("SAVRS") originally bearing interest at the SAVRS rate for each 35-day auction rate period; the variable rate swapped to a synthetic fixed rate of 3.83% (see Note 5) in 2004, interest payable semiannually, principle payable annually to February 1, 2032	56,250	58,900
Series 2002C Waco Education Finance Corporation Taxable SAVRS bearing interest at the SAVRS rate for each 35-day auction rate period (1.32%. and 1.30% at May 31, 2004 and 2003, respectively), principal payable annually to Febuary 1, 2032	11,350	11,525
TOTAL NOTES & BONDS PAYABLE	$ 256,438	$ 261,209

The book values of notes and bonds payable were the same as the fair values as of May 31, 2004 and 2003.

Aggregate maturities of notes and bonds payable for the periods subsequent to May 31, 2004 are as follows:

(in thousands of dollars)

	2005	2006	2007	2008	2009	2010 AND THEREAFTER	TOTAL
Notes	$ 2,734	$ 2,770	$ 3,506	$ 1,741	$ 1,613	$ 4,574	$ 16,938
Bonds	6,200	6,475	6,750	4,850	5,075	210,150	239,500
TOTAL	$ 8,934	$ 9,245	$ 10,256	$ 6,591	$ 6,688	$ 214,724	$ 256,438

5. DERIVATIVE FINANCIAL INSTRUMENTS

The University has limited involvement with derivative financial instruments and does not use them for trading purposes. The University has entered into long-term interest rate swap agreements with a financial institution counterparty. The purpose of these agreements is to swap the University's Series 2002A variable rate demand bonds having a notional amount of $174,800,000 for a fixed rate of 4.91% through February 1, 2032 and to swap the University's Series 2002B variable rate demand bonds having a notional amount of $58,900,000 for a synthetic fixed rate of 3.83% under a BMA-based structure through February 1, 2032. The University entered into the swap agreement to obtain fixed rate financing at the lowest available cost at the time of the transaction. The value of the swap instrument represents the estimated cost to terminate the swap agreement at the reporting date, taking into account current and projected interest rates. The fair value of the interest rate swap included in the University's balance sheets as a liability at May 31, 2004 and 2003 was $24,790,000 and $41,711,000, respectively. To control credit risk, the University considered the credit rating and reputation of the counterparty before entering into the transaction and will monitor the credit standing of its counterparty during the life of the transaction.

The net change in assets resulting from changes in the swaps' fair value resulted in a gain of $16,921,000 as of May 31, 2004. and a loss of $26,291,000 as of May 31, 2003.

6. RETIREMENT PLAN

The University has a noncontributory retirement plan covering all full-time faculty and staff. The plan is a defined contribution plan and is administered by outside agencies. Retirement benefits equal the amount accumulated to each individual employee's credit at the date of retirement. The University's contributions to the plan for the years ended May 31, 2004 and 2003 were $9,163,000 and $8,463,000, respectively.

7. POSTRETIREMENT BENEFITS

The University provides medical and life insurance benefits for eligible retired faculty and staff. Currently, substantially all of the University's full-time faculty and staff become eligible for these benefits upon reaching age 55 and having 20 years of full-time service at retirement. The lifetime maximum on group medical benefits is $2,000,000, and the maximum benefit for life insurance is $20,000. The factors in the calculation of medical benefits include retiree premium contributions, deductibles and coinsurance provisions that are assumed to grow with the medical inflation rate.

Effective June 1, 2002, employees attaining the age of 55 with 20 years of continuous, full-time service at the University as of May 31, 2007 will continue under the postretirement medical and life insurance programs in effect before June 1, 2002. Those employees not meeting the above eligibility requirements may still participate in the postretirement medical program but will receive no postretirement life insurance benefits and will not be reimbursed for medicare Part B premiums. Under the new plan, all full-time faculty and staff become eligible for postretirement benefits upon reaching age 55 and having 10 years of full-time service at retirement.

The University follows the provisions of Statement of Financial Accounting Standards ("SFAS") No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. This statement requires that the expected cost of postretirement benefits be charged to operations on an accrual basis during the years that the faculty and staff render service. SFAS No. 106 also requires that the accumulated obligation at the implementation date be recognized as a liability and that an offsetting amount be recognized as a reduction in fund balance or amortized as an expenditure over 20 years. The University chose to amortize the accumulated postretirement benefits over 20 years.

The benefit obligation, which represents the actuarial present value of benefits attributed to employee service rendered as of May 31, 2004 and 2003, for the unfunded plan, include the following components:

(in thousands of dollars)

	2004	2003
Benefit obligation at May 31	$ 28,566	$ 23,895
Fair value of plan assets at May 31	—	—
Funded status	$ (28,566)	$ (23,895)
Adjusted accrued benefit liability	$ (10,747)	$ (8,663)
Weighted-average assumptions as of May 31:		
Discount rate	6.50%	6.00%
Expected return on plan assets	N/A	N/A
Rate of compensation increase	4.00%	4.00%
Initial trend rate	10.25%	11.00%
Ultimate trend rate	5.00%	5.00%
Years to ultimate	7	8

The benefit obligation at May 31, 2004 is determined using an assumed medical cost trend rate of 10.25%. The medical cost trend rates are assumed to decrease gradually to 5% over seven years and remain at that level thereafter.

	(in thousands of dollars)	
	2004	**2003**
Net periodic benefit cost	$ 3,133	$ 2,381
Employer contribution	1,048	968
Plan participants' contribution	832	713
Benefits paid	1,880	1,681

Medical cost trend rate assumptions have a significant impact on the amounts reported. A one percentage point increase in the assumed medical cost trend rate for each future year increases the medical portion of the total June 1, 2004 Accumulated Postretirement Benefit Obligation by $2,935,000.

8. OUTSTANDING LEGACIES

The University is the beneficiary under various wills and trust agreements, the realizable amounts of which are not presently determinable. The University's share of such bequests is recorded when the University has an irrevocable right to the bequest and the proceeds are measurable.

9. TAX STATUS

The University is exempt from income tax under Section 501(c)(3) of the Internal Revenue Code. The University has been classified as an organization that is not a private foundation, and contributions to it qualify for deduction as charitable contributions. The University files unrelated business income tax and other information returns as required by government authorities.

10. UNCONDITIONAL PROMISES TO GIVE

As pledges are made to the University, the intent of the donor, the circumstances surrounding the pledge, and any action taken by the University in response to the pledge are considered in determining whether the pledge is an "intent to give" or an "unconditional promise to give." An intent to give is not recorded as revenue until collected. An unconditional promise to give is recorded as a contribution receivable and as revenue at the present value of the estimated future cash flows.

Intents to give total $50,269,000 and $49,531,000 as of May 31, 2004 and 2003, respectively. Payments on these intents to give are due in varying periods.

As of May 31, 2004 and 2003, unconditional promises to give consist of the following:

	(in thousands of dollars)	
	2004	**2003**
Endowment Funds	$ 500	$ —
Building projects		
Due in 1 year	620	1,670
Due in 1-5 years	1,646	2,178
Split interest agreements	17,516	15,313
Less present value adjustment	(8,690)	(7,888)
TOTAL CONTRIBUTIONS RECEIVABLE	$ 11,592	$ 11,273

The unconditional promises to give related to split interest agreements are discounted based on life expectancies of the annuity recipients.

11. COMMITMENTS AND CONTINGENCIES

CAPITAL EXPENDITURES

The University is contractually obligated for amounts aggregating a maximum of approximately $14,266,000 and $79,412,000 at May 31, 2004 and 2003, respectively. Such obligations relate primarily to capital projects.

INVESTMENTS

As part of the University's alternative investments program, the University is obligated under certain limited partnership agreements to advance additional funding up to specified levels upon the request of the general partner. The University had unfunded commitments of $51,309,000 and $40,672,000 at May 31, 2004 and 2003, respectively, which are expected to be called over the next five years.

CONTINGENCIES

The University is a party to various legal proceedings and complaints arising in the ordinary course of operations, some of which are covered by insurance. The administration is not aware of any claims or contingencies, which are not covered by insurance, that would be material to the financial position of the University.

The University participates in several state and federal grant programs and must comply with requirements of the grantor agencies. The administration is of the opinion that the University is in compliance with these grantor requirements.

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