

Baylor University

Financial Statements

*Years Ended May 31, 2008 and 2007,
and Independent Auditors' Report*

BAYLOR UNIVERSITY

FINANCIAL STATEMENTS

Years Ended May 31, 2008 and 2007

TABLE OF CONTENTS

	<u>Page</u>
Independent Auditors' Report.....	1
Financial Statements as of and for the Years Ended May 31, 2008 and 2007:	
Balance Sheets	2 - 3
Statements of Activities	4 - 5
Statements of Cash Flows	6
Notes to Financial Statements.....	7 - 20

INDEPENDENT AUDITORS' REPORT

Board of Regents
Baylor University

We have audited the accompanying balance sheets of Baylor University (the "University") as of May 31, 2008 and 2007, 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University as of May 31, 2008 and 2007, 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.

As discussed in Note 8 to the financial statements, the University adopted the recognition and disclosure provisions of Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, as of May 31, 2008.

As discussed in Note 2 to the financial statements, the financial statements include alternative assets valued at approximately \$524,052,000 (36% of net assets) and \$353,416,000 (25% of net assets) as of May 31, 2008 and 2007, respectively, whose fair values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or general partners.

Deloitte & Touche LLP

September 23, 2008

BAYLOR UNIVERSITY
Balance Sheets

May 31, 2008 and 2007
(in thousands of dollars)

	May 31, 2008			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
<u>ASSETS</u>				
Cash & cash equivalents	\$ 4,958	\$ 9,672	\$ 264	\$ 14,894
Short-term investments	26,983	4,693	841	32,517
Bond proceeds held by trustees	2,838	--	--	2,838
Student accounts receivable, net	12,573	--	--	12,573
Contributions, grants & other receivables	23,385	10,810	6,083	40,278
Prepaid expenses & other	5,478	17	--	5,495
Student loans receivable, net	8,589	--	5,447	14,036
Long-term investments, at fair value	505,430	93,306	542,327	1,141,063
Property, plant & equipment, net	599,993	--	--	599,993
Total assets	\$ 1,190,227	\$ 118,498	\$ 554,962	\$ 1,863,687
<u>LIABILITIES & NET ASSETS</u>				
Liabilities				
Accounts payable	\$ 21,345	\$ 281	\$ 476	\$ 22,102
Personnel related liabilities	16,120	--	--	16,120
Deposits & deferred income	35,122	514	--	35,636
Notes & bonds payable	277,454	--	--	277,454
Interest rate swap liability	22,852	--	--	22,852
Accrued postretirement benefits	33,754	--	--	33,754
Other liabilities	10,806	1,239	4,389	16,434
Total liabilities	417,453	2,034	4,865	424,352
Net Assets				
Unrestricted operating	26,699	--	--	26,699
Restricted	--	11,382	6,693	18,075
Endowment	304,227	65,587	525,030	894,844
Endowment - Board designated	161,710	12,380	--	174,090
Annuity & living trusts	--	14,758	18,374	33,132
Net invested in plant	280,138	12,357	--	292,495
Total net assets	772,774	116,464	550,097	1,439,335
Total liabilities & net assets	\$ 1,190,227	\$ 118,498	\$ 554,962	\$ 1,863,687

See accompanying notes to financial statements.

May 31, 2007			
Unrestricted	Temporarily Restricted	Permanently Restricted	Total
\$ 15,286	\$ 20,638	\$ 5,157	\$ 41,081
47,734	--	--	47,734
24,000	--	--	24,000
10,977	--	--	10,977
21,558	12,545	6,473	40,576
8,409	596	--	9,005
8,458	--	5,704	14,162
483,577	82,754	514,108	1,080,439
563,537	--	--	563,537
<u>\$ 1,183,536</u>	<u>\$ 116,533</u>	<u>\$ 531,442</u>	<u>\$ 1,831,511</u>

\$ 29,439	\$ 363	\$ 490	\$ 30,292
14,883	--	--	14,883
31,516	1,276	--	32,792
290,670	--	--	290,670
19,380	--	--	19,380
18,259	--	--	18,259
10,585	1,284	4,518	16,387
<u>414,732</u>	<u>2,923</u>	<u>5,008</u>	<u>422,663</u>

35,248	--	--	35,248
--	9,754	6,529	16,283
289,120	62,852	497,883	849,855
153,081	11,108	--	164,189
--	15,488	22,022	37,510
291,355	14,408	--	305,763
<u>768,804</u>	<u>113,610</u>	<u>526,434</u>	<u>1,408,848</u>
<u>\$ 1,183,536</u>	<u>\$ 116,533</u>	<u>\$ 531,442</u>	<u>\$ 1,831,511</u>

BAYLOR UNIVERSITY
Statements of Activities

For the Years Ended May 31, 2008 and 2007
(in thousands of dollars)

in thousands of dollars)

	Year Ended May 31, 2008			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES				
Tuition & fees	\$ 342,098	\$ --	\$ --	\$ 342,098
Less scholarships	(119,362)	--	--	(119,362)
Net tuition & fees	222,736	--	--	222,736
Gifts, private grants & Baptist General Convention of Texas appropriation	15,244	6,759	21,581	43,584
Investment income	5,618	410	859	6,887
Endowment earnings distributed	40,239	6,088	2,281	48,608
Government grants & contracts	3,773	20,814	--	24,587
Other sources - educational & general	17,784	1,833	--	19,617
Other sources - intercollegiate athletics	15,902	--	--	15,902
Sales & services of auxiliary enterprises	33,960	--	--	33,960
Total revenues	355,256	35,904	24,721	415,881
Net assets released from restrictions	36,111	(36,025)	(86)	--
Total net revenues	391,367	(121)	24,635	415,881
EXPENSES				
Program expenses				
Instruction	176,204			176,204
Academic support, research & public service	53,349			53,349
Student services & activities	66,777			66,777
Auxiliary enterprises	33,569			33,569
Support expenses				
Institutional support	48,269			48,269
Total expenses	378,168	--	--	378,168
Increase (decrease) in net assets before other changes	13,199	(121)	24,635	37,713
OTHER CHANGES				
Gains (losses) on investments, net of distributions	20,442	3,109	(212)	23,339
Unrealized loss on interest rate swap	(3,472)	--	--	(3,472)
Loss on disposal of property & equipment	(2,114)	--	--	(2,114)
Effect of debt refunding -				
Realized loss on interest rate swaps	(7,162)	--	--	(7,162)
Write off of debt issuance costs	(4,253)	--	--	(4,253)
Change in value of split interest agreements -				
Present value adjustments	--	225	(760)	(535)
Terminated annuities	359	(359)	--	--
Total other changes	3,800	2,975	(972)	5,803
Increase in net assets before cumulative effect of change in accounting principle	16,999	2,854	23,663	43,516
Cumulative effect of change in accounting principle				
Accrued postretirement benefits	(13,029)	--	--	(13,029)
Asset retirement obligations	--	--	--	--
Increase (decrease) in net assets	3,970	2,854	23,663	30,487
Net assets at beginning of year	768,804	113,610	526,434	1,408,848
Net assets at end of year	\$ 772,774	\$ 116,464	\$ 550,097	\$ 1,439,335

See accompanying notes to financial statements.

Year Ended May 31, 2007			
Unrestricted	Temporarily Restricted	Permanently Restricted	Total
\$ 313,900	\$ --	\$ --	\$ 313,900
(106,122)	--	--	(106,122)
207,778	--	--	207,778
15,118	16,253	18,440	49,811
9,002	435	695	10,132
39,801	5,772	2,804	48,377
3,468	20,739	--	24,207
17,499	1,130	--	18,629
15,833	--	--	15,833
29,029	--	--	29,029
337,528	44,329	21,939	403,796
39,890	(40,069)	179	--
377,418	4,260	22,118	403,796
160,457			160,457
50,789			50,789
59,218			59,218
28,410			28,410
44,451			44,451
343,325	--	--	343,325
34,093	4,260	22,118	60,471
100,470	14,424	5,981	120,875
(2,967)	--	--	(2,967)
(2,222)	--	--	(2,222)
--	--	--	--
--	--	--	--
--	2,543	2,657	5,200
--	--	--	--
95,281	16,967	8,638	120,886
129,374	21,227	30,756	181,357
--	--	--	--
(2,685)	--	--	(2,685)
126,689	21,227	30,756	178,672
642,115	92,383	495,678	1,230,176
\$ 768,804	\$ 113,610	\$ 526,434	\$ 1,408,848

BAYLOR UNIVERSITY
Statements of Cash Flows

For the Years Ended May 31, 2008 and 2007
(in thousands of dollars)

	Year Ended May 31, 2008	Year Ended May 31, 2007
<u>CASH FLOWS FROM OPERATING ACTIVITIES</u>		
Increase in Net Assets	\$ 30,487	\$ 178,672
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Cumulative effect of change in accounting principle	13,029	2,685
Depreciation	27,751	26,458
Net realized & unrealized gains on investments	(23,339)	(120,875)
Unrealized loss on interest rate swap	3,472	2,967
Realized loss on interest rate swaps	7,162	--
Write off of debt issuance costs	4,253	--
Loss on disposal of property & equipment	2,114	2,222
Contributions restricted for permanent investment	(21,581)	(18,440)
Decrease (increase) in:		
Short-term investments	15,217	12,490
Student accounts receivable	(1,596)	(1,445)
Contributions, grants & other receivables	298	(2,439)
Prepaid expenses & other	412	(812)
Increase (decrease) in:		
Accounts payable	(8,190)	12,095
Personnel related liabilities	1,237	1,271
Deposits & deferred income	2,844	3,683
Accrued postretirement benefits	2,466	2,144
Other liabilities	21	70
Net cash provided by operating activities	<u>56,057</u>	<u>100,746</u>
<u>CASH FLOWS FROM INVESTING ACTIVITIES</u>		
Student loans made	(885)	(1,241)
Proceeds from collections of student loans	1,011	1,524
Proceeds from sales of long-term investments	110,303	23,663
Purchases of long-term investments	(147,588)	(70,570)
Purchases of property, plant & equipment	(66,321)	(70,429)
Net cash used in investing activities	<u>(103,480)</u>	<u>(117,053)</u>
<u>CASH FLOWS FROM FINANCING ACTIVITIES</u>		
Contributions restricted for permanent investment:		
Endowment	19,896	18,289
Annuity & living trusts	1,685	151
Unexpended bond proceeds decrease	21,162	39,255
Proceeds from long-term debt	271,200	--
Repayment of long-term debt	(284,416)	(11,034)
Payment of interest rate swap liability	(7,162)	--
Debt issuance costs	(1,155)	--
Increase in federal student loan funds refundable	26	22
Net cash provided by financing activities	<u>21,236</u>	<u>46,683</u>
Net increase (decrease) in cash & cash equivalents	<u>(26,187)</u>	<u>30,376</u>
Cash & cash equivalents at beginning of year	<u>41,081</u>	<u>10,705</u>
Cash & cash equivalents at end of year	<u>\$ 14,894</u>	<u>\$ 41,081</u>

See accompanying notes to financial statements.

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

OVERVIEW OF BAYLOR UNIVERSITY

The mission of Baylor University (the "University") is to educate men and women for worldwide leadership and service by integrating academic excellence and Christian commitment within a caring community.

Chartered in 1845 by the Republic of Texas and affiliated with the Baptist General Convention of Texas, the University is both the state's oldest institution of higher learning and the world's largest Baptist university. Established to be a servant of the church and of society, the University seeks to fulfill its calling through excellence in teaching and research, in scholarship and publication, and in service to the community, both local and global. The 800-acre campus is located on the banks of the Brazos River in Waco, Texas, a metropolitan area of 200,000 people.

While remaining true to its Christian heritage, the University has grown to approximately 14,000 students, and its nationally recognized academic units offer 150 undergraduate, 76 master's, a Juris Doctor and 23 doctoral degree programs.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting & Reporting

The financial statements of 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 Bear 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 in conformity with accounting principles generally accepted in the United States of America. 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.

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

Cash & Cash Equivalents

Cash on deposit and all highly liquid financial instruments with maturities of three months or less are classified as cash and cash equivalents, except those amounts assigned to investment managers, which are classified as investments. Cash and cash equivalents reflected in the accompanying balance sheets as temporarily or permanently restricted are funds from contributions that have donor-imposed restrictions limiting their use to future investment in plant or are awaiting long-term investment for other long-term purposes.

Short-Term Investments

Short-term investments consist of operational funds invested in bank time deposits, short-term U.S. government securities, those having maturities longer than three months but less than one year, and highly liquid money market funds. Short-term investments reflected in the accompanying balance sheets as temporarily or permanently restricted are funds from contributions that have donor-imposed restrictions limiting their use to future investment in plant or are awaiting long-term investment for other long-term purposes.

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 to be paid for endowments participating in the BUF for the purposes intended by the donors. This policy attempts to meet three objectives: (1) provide a predictable, stable stream of earnings to participating accounts; (2) ensure that the purchasing power of this revenue stream does not decline over time; and (3) ensure that the purchasing power of the endowment assets do not decline over time. Under this policy, actual earnings, as well as a prudent portion of realized and unrealized gains, may be distributed for operational needs or in accordance with donor restrictions. For the years ended May 31, 2008 and 2007, this dividend was based on 5% of the previous 48 months' average market value per unit of the BUF subject to a 0% minimum (a 3% minimum for the year ended May 31, 2007) and a 6% maximum dividend rate increase from the previous year. The dividend rate did not change during the years ended May 31, 2008 and 2007.

Endowment earnings distributed includes endowment distributions in accordance with the University's BUF spending policy, as well as, distributions from other endowment assets.

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 long-term 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 11). Annuities payable are recorded at the present value of future payments, based on the Internal Revenue Service ("IRS") discount rate at the time of the original gift.

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

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 included in other liabilities in the accompanying balance sheets.

Property, Plant & Equipment

Property, plant and equipment valued at \$5,000 or more are recorded at cost at the date of acquisition or, if acquired by gift, at estimated fair value at the 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.

Conditional asset retirement obligations related to legal requirements to perform certain future activities related to the retirement, disposal or major renovation of assets are accrued utilizing site-specific surveys to estimate the net present value for applicable future costs, e.g., asbestos abatement or removal.

The University reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment charge is recognized when the fair value of the asset is less than the carrying value.

Deposits & Deferred Income

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

Fair Value of Financial Instruments

The estimated fair values of financial instruments that differ from the carrying amounts have been determined by the University using available market information. The estimates are not necessarily indicative of the amounts the University could realize in a current market exchange.

The carrying amounts of cash and cash equivalents, short-term investments, bond proceeds held by trustees, student accounts receivable, prepaid expenses and other assets, accounts payable, personnel related liabilities and deposits and deferred income approximate fair value because of the short maturity of these financial instruments.

A reasonable estimate of the fair value of loans receivable from students under government loan programs could not be determined because the loans receivable cannot be sold and can only be assigned to the U.S. government or its designees. The fair value of loans receivable from students under University loan programs approximates carrying value.

Tuition & Fees

Tuition and fees revenues are recognized in the fiscal year during which the related semester concludes. Scholarships provided by the University for tuition and fees are reflected as a reduction of tuition and fees revenues. Scholarships are awarded to students by the University from unrestricted revenues, restricted endowment earnings, restricted gifts or government grants. Scholarships do not include payments to students for services rendered to the University.

Contributions

Contributions are recorded as revenues in the appropriate net asset class based on donor-imposed restrictions. Expiration of temporary restrictions on donor contributions are reported as net assets released from restrictions. 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.

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

Contributions receivable are recorded at the present value of estimated future cash flows using an average discount rate in effect in the year the contribution was recorded.

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, interest expense and operation and maintenance of plant have been allocated directly or based on square footage among the functional categories.

Fundraising expenses of approximately \$12,830,000 and \$11,350,000 incurred by the University in 2008 and 2007, respectively, are included primarily in the institutional support category in the statements of activities.

Use of Estimates & Assumptions

The preparation of financial statements requires management to make estimates and assumptions that affect reported amounts of assets, liabilities, revenues and expenses during the reporting period, as well as the disclosure of contingent assets and liabilities. Significant items subject to such estimates and assumptions include valuations of certain investments which do not have readily determinable fair values, allowances for uncollectible accounts and contingency reserves, calculations of asset retirement obligations and actuarially determined liabilities related to postretirement benefit plans. Actual results ultimately could differ from management's estimates and assumptions.

Other

During the year ended May 31, 2008, the reporting of funds received from the Texas Higher Education Coordinating Board as part of the Tuition Equalization Grant Program ("TEG") was changed to be included as a component of scholarships and government grants and contracts revenues. This change was made to reflect a change in how TEG is administered by the Texas Higher Education Coordinating Board. To be comparable with the year ended May 31, 2008 reporting, \$11,935,000 of funds received and awarded to students from the TEG program during the year ended May 31, 2007, and previously not included in the University's scholarships or government grants and contracts revenues, have been included in the accompanying 2007 statement of activities as a component of scholarships and government grants and contracts revenues. This change has no impact on total net revenues or net assets as previously reported in the 2007 financial statements.

During the year ended May 31, 2008, the reporting of realized gains (losses) on investments was combined with unrealized gains (losses) on investments and the combined amount reported as gains (losses) on investments, net of distributions in the other changes section of the statement of activities. This change was also made in the accompanying 2007 statement of activities for comparability with the 2008 statement.

2. LONG-TERM INVESTMENTS

The University's long-term investments are recorded at fair value. The estimated fair value of investments is based on quoted market prices, except for certain alternative assets for which quoted market prices are not available. The estimated fair value of these alternative assets is based on the most recent valuations provided by the external investment managers, adjusted for receipts and disbursements through May 31. The University reviewed and evaluated the values provided by the managers and agreed with the valuation methods and assumptions used to determine those values. Therefore, the University believes the carrying amount of these financial instruments is a reasonable estimate of the fair value. Because alternative assets are not readily marketable, their estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for such investments existed.

BAYLOR UNIVERSITY
NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

Cost and estimated fair value of investments as of May 31, 2008 and 2007, are as follows:

	<i>(in thousands of dollars)</i>			
	2008		2007	
	<u>Cost</u>	<u>Estimated Fair Value</u>	<u>Cost</u>	<u>Estimated Fair Value</u>
Investments:				
Debt securities	\$ 57,378	\$ 78,393	\$ 65,230	\$ 93,593
Equity securities	336,660	509,540	365,660	580,624
Alternative assets	331,180	524,052	220,205	353,416
Real estate	10,178	15,391	7,544	17,802
Mineral rights	3,489	9,995	13,121	34,003
Other	3,217	3,692	708	1,001
Total investments	<u>\$ 742,102</u>	<u>\$1,141,063</u>	<u>\$ 672,468</u>	<u>\$1,080,439</u>

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

Alternative assets are not as liquid as other University investments. Alternative assets are invested with sixty-five different managers. The total fair values by strategy type are as follows:

	<i>(in thousands of dollars)</i>	
	2008	2007
Alternative assets:		
Private equity	\$ 134,388	\$ 117,722
Absolute return	167,211	111,015
Real assets	222,453	124,679
Total alternative assets	<u>\$ 524,052</u>	<u>\$ 353,416</u>

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 assets.

Investments include interests in split interest agreements. The fair values representing interests in split interest agreements are \$169,506,000 and \$170,546,000 as of May 31, 2008 and 2007, respectively.

Investment returns for the years ended May 31, 2008 and 2007, consist of the following:

	<i>(in thousands of dollars)</i>	
	2008	2007
Endowment earnings distributed	\$ 48,608	\$ 48,377
Net appreciation, realized and unrealized	23,340	120,875
Total investment returns	<u>\$ 71,948</u>	<u>\$ 169,252</u>

The total investment returns are net of investment expenses of \$5,138,000 and \$6,878,000 for the years ended May 31, 2008 and 2007, respectively.

BAYLOR UNIVERSITY
NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

3. PROPERTY, PLANT & EQUIPMENT

At May 31, 2008 and 2007, property, plant and equipment assets consist of the following:

	<i>(in thousands of dollars)</i>	
	2008	2007
Land	\$ 40,923	\$ 30,755
Buildings	622,886	558,322
Equipment	65,641	62,518
Other	<u>105,339</u>	<u>99,100</u>
	834,789	750,695
Less accumulated depreciation	<u>(265,146)</u>	<u>(243,244)</u>
	569,643	507,451
Construction-in-progress	<u>30,350</u>	<u>56,086</u>
Property, plant & equipment, net	<u>\$ 599,993</u>	<u>\$ 563,537</u>

Depreciation expense was \$27,751,000 and \$26,280,000 for the years ended May 31, 2008 and 2007, respectively. The University recognized accretion expense of \$177,000 and \$178,000 associated with its conditional asset retirement obligations for the years ended May 31, 2008 and 2007, respectively. Real and personal property were insured for \$1.3 billion at May 31, 2008 and 2007.

4. NOTES & BONDS PAYABLE

Notes and 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, 2036 were \$277,454,000 and \$290,670,000 at May 31, 2008 and 2007, respectively. Interest payments on a cash basis totaled \$15,443,000 and \$13,206,000, and interest expense was \$15,560,000 and \$13,195,000 for the years ended May 31, 2008 and 2007, respectively.

During the year ended May 31, 2008, the University issued \$271,200,000 of tax-exempt refunding bonds through the Waco Education Finance Corporation in order to refund the Series 2002 and 2006 bonds. An effect of the refunding of the Series 2002 and 2006 bonds is a non-operating charge in the year ended May 31, 2008 of \$4,253,000 for the write off of unamortized bond issuance costs. As of May 31, 2008 and 2007, unamortized bond issuance costs of \$1,147,000 and \$4,389,000, respectively, are included in prepaid expenses and other in the University's balance sheets. Amortization expense for issuance costs was \$181,000 and \$196,000 for the years ended May 31, 2008 and 2007, respectively.

Earnings of \$300,000 and \$2,423,000, for the years ended May 31, 2008 and 2007, respectively, on the Series 2006 Waco Education Finance Corporation Tax-Exempt Variable Rate Demand Bond proceeds, exceeded capitalizable interest expense. Therefore, no net interest expense was capitalized to projects for the years ended May 31, 2008 and 2007.

Notes and bonds payable at May 31, 2008 and 2007, consist of the following:

	<i>(in thousands of dollars)</i>	
	2008	2007
Non-interest bearing unsecured note payable to a foundation, due in annual installments of \$500,000 to June 30, 2013	\$ 3,000	\$ 3,500
Non-interest bearing unsecured note payable to a foundation, due in quarterly installments as repayments from loans to students are received	597	898
Non-interest bearing unsecured notes payable to a corporation, due in monthly installments through September 1, 2008	84	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	2,503	3,023

BAYLOR UNIVERSITY
NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

	<i>(in thousands of dollars)</i>	
	2008	2007
Non-interest bearing unsecured note payable to a private entity, due in annual installments of \$70,000 to June 30, 2008	70	140
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	--	162,525
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 2005, interest payable semiannually	--	46,775
Series 2002C Waco Education Finance Corporation Taxable SAVRS, bearing interest at the SAVRS rate for each 35-day auction rate period	--	10,775
Series 2006 Waco Education Finance Corporation Tax-Exempt Variable Rate Demand Bonds, swapped to a synthetic fixed rate of 3.543% (see Note 5), interest payable monthly	--	62,700
Series 2008A 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	79,550	--
Series 2008B 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	79,550	--
Series 2008C Waco Education Finance Corporation Tax-Exempt Fixed Rate Bonds, interest ranging from 5.0% to 5.25% payable semiannually, principal payable annually beginning 2019 to February 1, 2036	112,100	--
Total notes & bonds payable	<u>\$277,454</u>	<u>\$290,670</u>

The fair values of notes and bonds payable were approximately \$280,451,000 and \$290,169,000 as of May 31, 2008 and 2007, respectively.

Principal and interest on notes and bonds for the periods subsequent to May 31, 2008, are as follows:

	<i>(in thousands of dollars)</i>						
	2009	2010	2011	2012	2013	2014 and Thereafter	Total
Principal	\$ 5,063	\$ 5,026	\$ 5,222	\$ 5,443	\$ 4,875	\$ 251,825	\$ 277,454
Interest	11,642	13,461	13,230	12,986	12,731	183,284	247,334
Total	<u>\$ 16,705</u>	<u>\$ 18,487</u>	<u>\$ 18,452</u>	<u>\$ 18,429</u>	<u>\$ 17,606</u>	<u>\$ 435,109</u>	<u>\$ 524,788</u>

5. DERIVATIVE FINANCIAL INSTRUMENTS

The University has entered into a long-term interest rate swap agreement with a financial institution counterparty to manage the interest cost and risk associated with its outstanding debt. The purpose of this agreement is to swap the University's Series 2008A/B variable rate demand bonds having a balance of \$159,100,000 as of May 31, 2008, for a fixed rate of 4.91% through February 1, 2032. The swap agreements related to the Series 2002B and 2006 bond issues were terminated at the time these issues were refunded resulting in a realized loss of \$3,497,000 and \$3,665,000, respectively. The value of swap instruments represent the estimated cost to terminate at the reporting date, taking into account current and projected interest rates. The fair value of the interest rate swaps included in the University's balance sheets as a liability at May 31, 2008 and 2007, was \$22,852,000 and \$19,380,000, respectively. To control credit risk, the University considered the credit rating and reputation of the counterparty before entering into the transaction and monitors the credit standing of its counterparty. The change in

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

net assets resulting from changes in the swaps' fair values resulted in unrealized losses of \$3,472,000 and \$2,967,000 for the years ended May 31, 2008 and 2007, respectively.

During the year ended May 31, 2008, the University entered into a \$25,700,000 total return investment swap agreement with a financial institution. This swap agreement is an investment of the BUF and is reflected in the market value of the BUF on the University's financial statements for the year ended May 31, 2008.

6. EXPENSES BY NATURAL CLASSIFICATION

While the statements of activities present expenses by function, the University's expenses by natural classification are as follows:

	<i>(in thousands of dollars)</i>	
	2008	2007
Salaries & wages	\$ 146,952	\$ 133,183
Personnel benefits	46,478	42,950
Student wages & fellowships	15,147	13,881
Operating expenses	126,103	113,658
Depreciation & accretion	27,928	26,458
Interest on indebtedness	15,560	13,195
Total expenses	<u>\$ 378,168</u>	<u>\$ 343,325</u>

7. 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, 2008 and 2007, were \$12,266,000 and \$10,159,000, respectively.

8. POSTRETIREMENT BENEFITS

The University provides medical and life insurance benefits for eligible retired faculty and staff. Employees are eligible for such benefits if they retire after attaining specified age and service requirements while employed by the University. Through May 31, 2002, full-time faculty and staff became 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, 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 net assets or amortized as expenditure over 20 years. The University chose to amortize the accumulated postretirement benefits over 20 years.

BAYLOR UNIVERSITY
NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

The following tables set forth the required disclosures and unfunded status of postretirement benefits as well as the components of net periodic benefit costs and weighted-average assumptions as of the measurement date, May 31:

	<i>(in thousands of dollars)</i>	
	2008	2007
<u>Change in benefit obligation:</u>		
Measurement date	5/31/2008	5/31/2007
Accumulated postretirement benefit obligation (APBO)		
at beginning of year	\$ 30,331	\$ 27,052
Service cost	833	691
Interest cost	1,812	1,673
Plan participants' contributions	1,217	1,138
Plan amendment	--	--
Actuarial (gain) loss	2,036	2,108
Retiree drug subsidy paid	315	--
Benefit payments	(2,790)	(2,331)
Accumulated postretirement benefit obligation (APBO)		
at end of year	\$ 33,754	\$ 30,331
<u>Change in plan assets:</u>		
Fair value of plan assets at beginning of year	\$ --	\$ --
Actual return on plan assets	--	--
Employer contributions	1,572	1,193
Plan participants' contributions	1,218	1,138
Benefit payments	(2,790)	(2,331)
Fair value of plan assets at end of year	\$ --	\$ --
<u>Funded status of plan:</u>		
Excess of (benefit obligation) over/(under) plan assets	\$ (33,754)	\$ (30,331)
Unrecognized transition obligation	--	1,642
Unrecognized prior service cost	--	4,727
Unrecognized net loss	--	5,703
Accrued postretirement benefit cost	\$ (33,754)	\$ (18,259)
<u>Amounts recognized as changes in unrestricted net assets arising from postretirement benefits plan but not yet included in periodic benefit cost:</u>		
Unrecognized transition obligation	\$ 1,369	N/A
Unrecognized prior service cost	4,083	N/A
Unrecognized net loss	7,577	N/A
Total	\$ 13,029	--

The University expects to recognize \$1,170,000 of net losses, transition obligation and prior service cost as components of net periodic benefit cost during the fiscal year ending May 31, 2009.

BAYLOR UNIVERSITY
NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

Weighted-average assumptions at measurement date:

	2008	2007
Discount rate	6.75%	6.09%
Health care cost trend rate	9.00%	8.50%
Ultimate health care cost trend rate	5.00%	5.00%
Year ultimate trend rate reached	2016	2014

Contributions:

The University expects to contribute \$1,384,000 to its postretirement benefit plan during the fiscal year ending May 31, 2009.

Projected cash flows:

	<i>(in thousands of dollars)</i>	
	Gross Benefit Payments Net of Employee Contributions	Gross Subsidy Receipts
2009 Fiscal year	\$ 1,606	\$ 222
2010 Fiscal year	1,716	243
2011 Fiscal year	1,818	267
2012 Fiscal year	1,899	294
2013 Fiscal year	2,019	327
2014-2018 Fiscal years	12,342	2,260

Components of net periodic postretirement benefit cost:

	6/1/07-5/31/08	6/1/06-5/31/07
Measurement date	5/31/2007	5/31/2006
Service cost	\$ 833	\$ 691
Interest cost	1,812	1,673
Amortization of:		
Transition obligation	274	274
Prior service cost	643	643
Actuarial loss	161	56
Net periodic postretirement benefit cost	\$ 3,723	\$ 3,337

Weighted-average assumptions for net periodic postretirement benefit cost:

	5/31/2007	5/31/2006
Measurement date	5/31/2007	5/31/2006
Discount rate	6.09%	6.31%
Health care cost trend rate	8.50%	9.00%
Ultimate health care cost trend rate	5.00%	5.00%
Year ultimate trend rate reached	2014	2015

Other Information:

	<i>(in thousands of dollars)</i>	
	6/1/07-5/31/08	6/1/06-5/31/07
1% increase in trend rates		
Effect on service + interest cost	\$ 278	\$ 278
Effect on APBO	3,297	2,536
1% decrease in trend rates		
Effect on service + interest cost	\$ (216)	\$ (216)
Effect on APBO	(2,674)	(2,043)

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act), which introduced a prescription drug benefit under Medicare, was signed into law. Effective January 1, 2006, the University adjusted the premium structure for the retiree health and welfare benefit plan in order for the retiree prescription drug plan to qualify for the federal retiree drug subsidy. The University has determined that its retiree prescription drug plan is actuarially equivalent to the Standard Medicare Part D benefit and is thus eligible for the federal retiree drug subsidy beginning in 2006. The measures of APBO and net periodic postretirement benefit cost in the financial statements and accompanying notes reflect the effects of the Act on the plan.

As of May 31, 2008, the University adopted Financial Accounting Standards Board ("FASB") Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment to FASB Statements No. 87, 88, 106 and 132R. Statement No. 158 requires an employer to recognize the over funded or under funded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through changes in unrestricted net assets. At May 31, 2008, the under funded components of postretirement benefit costs prior to adopting Statement No. 158 were as follows:

	<i>(in thousands of dollars)</i>
Unrecognized transition obligation	\$ 1,369
Unrecognized prior service cost	4,083
Unrecognized net loss	<u>7,577</u>
Total unrecognized items	<u>\$ 13,029</u>

The cumulative effect of Statement No. 158 resulted in an increase in the postretirement benefit plan liability and a decrease in unrestricted net assets of \$13,029,000, recognized as a cumulative effect of change in accounting principle in the statement of activities for the year ended May 31, 2008.

9. 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.

10. TAX STATUS & ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES

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. A provision totaling \$124,000 and \$0 for unrelated business income taxes is included in the accompanying financial statements for the years ended May 31, 2008 and 2007, respectively.

The University adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), effective June 1, 2007. FIN 48 requires that the University recognize in its financial statements the financial effects of a tax position, if that position is more likely than not of being sustained upon examination, including resolution of any appeals or litigation processes, based upon the technical merits of the position. Tax positions taken related to the University's tax exempt status, unrelated business activities taxable income and the deductibility of expenses and other miscellaneous tax positions have been reviewed, and management is of the opinion that material positions taken by the University would more likely than not be sustained by examination. Accordingly, the University has not recorded an income tax liability for uncertain tax benefits. As of May 31, 2008, the University's tax years 2005 to 2008 remain subject to examination.

BAYLOR UNIVERSITY
NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

11. 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 or when converted to an unconditional promise to give. 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 \$22,687,000 and \$24,796,000 as of May 31, 2008 and 2007, respectively. Payments on these intents to give are due in varying periods.

As of May 31, 2008 and 2007, unconditional promises to give consist of the following:

	<i>(in thousands of dollars)</i>	
	2008	2007
Restricted current funds	\$ 409	\$ 426
Endowment funds	--	--
Plant projects:		
Due in 1 year	500	550
Due in 1 to 5 years	2,100	3,600
Split interest agreements	23,085	23,967
Less: Present value adjustment	(10,211)	(10,186)
Total contributions receivable	<u>\$ 15,883</u>	<u>\$ 18,357</u>

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

12. COMMITMENTS & CONTINGENCIES

Capital Expenditures

The University is contractually obligated for amounts aggregating a maximum of approximately \$20,764,000 and \$16,184,000 at May 31, 2008 and 2007, respectively. Such obligations relate primarily to capital projects.

Energy Purchase Agreement

On December 22, 2006, the University entered into a ten year fixed-price purchase agreement with an energy company to purchase, beginning in July, 2008, approximately 100,000,000 kilowatt-hours of electricity per year at a fixed rate of approximately \$.07 per kilowatt-hour. No amounts were paid for this agreement up front. Payments under this agreement will be made based upon the volume ordered at the contract price in the applicable periods. The cost of the electricity purchased through this agreement will be recorded as an expense in the period that the electricity is delivered.

Leases

The University incurred \$823,000 and \$637,000 in operating lease expenses for facilities and equipment in the fiscal years ended May 31, 2008 and 2007, respectively. As of May 31, 2008, the University has lease commitments for future periods totaling approximately \$1,981,000.

	<i>(in thousands of dollars)</i>						
	2009	2010	2011	2012	2013	2014 and Thereafter	Total
Equipment	\$ 575	\$ 531	\$ 531	\$ 168	\$ 47	\$ 8	\$ 1,860
Other	61	7	8	8	8	29	121
Total	<u>\$ 636</u>	<u>\$ 538</u>	<u>\$ 539</u>	<u>\$ 176</u>	<u>\$ 55</u>	<u>\$ 37</u>	<u>\$ 1,981</u>

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

Investments

As part of the University's alternative assets program, the University is obligated under certain limited partnership agreements to advance funding up to specified levels upon the request of the general partner. The University had unfunded commitments of \$226,753,000 and \$150,974,000 at May 31, 2008 and 2007, 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.

The University's Series 2002A tax-exempt bonds were selected in January, 2008 for an IRS examination. The University has provided the requested documentation related to the issuance of these tax-exempt bonds. Subsequent to May 31, 2008, the University has received an examination closing letter from the IRS stating "no change" to the tax exempt status of these bonds.

13. ASSET RETIREMENT OBLIGATIONS & RELATED CUMULATIVE EFFECT OF ACCOUNTING CHANGE

During the fiscal year ended May 31, 2007, the University adopted FASB Interpretation No. 47 ("FIN 47"), *Accounting for Conditional Asset Retirement Obligations* (an interpretation of FASB Statement No. 143). This interpretation provided clarification with respect to the timing of liability recognition for legal obligations associated with the retirement of tangible long-lived assets when the timing and/or method of settlement of the obligation is conditional on a future event. This interpretation requires that the fair value of a liability for a conditional asset retirement obligation be recognized in the period in which it occurred if a reasonable estimate of fair value can be made. As a result of implementing FIN 47 in fiscal year ended May 31, 2007, the University recognized asset retirement obligations related primarily to asbestos contamination in buildings and recorded a non-cash transition charge of \$2,685,000, which is reported as a cumulative effect of a change in accounting principle in the statements of activities. The liability for conditional asset retirement obligations was \$3,413,000 and \$3,218,000 as of May 31, 2008 and 2007, respectively, and is included in other liabilities in the accompanying balance sheets. In addition, upon adoption of FIN 47, the University capitalized \$989,000 of asset retirement costs with an accumulated depreciation balance of \$635,000 as of May 31, 2007.

14. NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, FASB issued Statement No. 157, *Fair Value Measurements*. The statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The University is in the process of determining the financial impact of Statement No. 157.

In February 2007, FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, including an amendment to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The statement permits entities to choose to measure financial instruments and other items at fair value that are not currently required to be measured at fair value. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The University is in the process of determining the financial impact of Statement No. 159.

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2008 and 2007

In March 2008, FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. The statement requires qualitative disclosures about the objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk related contingent features in derivative instruments. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2008. The University is in the process of determining the financial impact of Statement No. 161.

In August 2008, FASB issued FASB Staff Position (FSP) FAS 117-1, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act and Enhanced Disclosures for All Endowment Funds*. The FSP responds to accounting questions raised by the model Uniform Prudent Management of Institutional Funds Act (UPMIFA) that was approved by the Uniform Law Commission in July 2006 to modernize the Uniform Management of Institutional Funds Act of 1972 (UMIFA) for governing the investment and management of donor-restricted endowment funds by not-for-profit organizations. Effective September 2007, the State of Texas enacted UPMIFA. Among UPMIFA's most significant changes is the elimination of UMIFA's concept of historic dollar value threshold, the amount below which an organization could not spend from the fund, in favor of a more robust set of guidelines about what constitutes prudent spending. The provisions of the FSP expand disclosures about an organization's endowment funds (both donor-restricted and board-designated). In addition, the FSP requires that the portion of a donor-restricted endowment fund that is not classified as permanently restricted net assets be classified as temporarily restricted net assets until appropriated for expenditure. The University has determined that retaining its existing policies regarding net asset classification of its donor-restricted endowment funds is appropriate as of May 31, 2008, based on accounting standards in effect. The provisions of the FSP are effective for fiscal years ending after December 15, 2008. Accordingly, the University will adopt the FSP for the year ending May 31, 2009.

15. SUBSEQUENT EVENTS

On July 25, 2008, the University's Board of Regents authorized the establishment of a commercial paper program to provide an additional financing source for University projects and other purposes. Under the program, the University may issue from time to time taxable and/or tax-exempt notes in one or more series or sub-series in an aggregate principal amount outstanding at any time not to exceed \$50,000,000.

On September 15, 2008, the guarantor of the University's long-term interest rate swap agreement with a financial institution counterparty filed for bankruptcy. As discussed in Note 5, the swap agreement is used to manage the interest cost and risk associated with a portion of the University's outstanding debt. While the financial institution counterparty itself has not filed for bankruptcy at the time of issuance of these financial statements, the filing of bankruptcy by the guarantor has created an event of default under the terms of the swap agreement. The event of default provides the University with an ongoing right to early termination of the agreement. At the time of issuance of these financial statements, the University has not exercised its right to terminate the swap agreement. The event of default does not currently expose the University to increased risk; however, if the counterparty stops making payments under the swap agreement, Baylor will face higher interest payouts in the short-term. The University continues to monitor the situation and the overall uncertainty in the financial markets