

Baylor University

Financial Statements

*Years Ended May 31, 2006 and 2005, and
Independent Auditors' Report*

BAYLOR UNIVERSITY

FINANCIAL STATEMENTS

Years Ended May 31, 2006 and 2005

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INDEPENDENT AUDITORS' REPORT

Board of Regents
Baylor University

We have audited the accompanying balance sheets of Baylor University (the "University") as of May 31, 2006 and 2005, 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 and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 above financial statements present fairly, in all material respects, the financial position of the University as of May 31, 2006 and 2005, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 4, 2006 on our consideration of the University's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

October 4, 2006

BAYLOR UNIVERSITY
Balance Sheets

May 31, 2006 and 2005
(in thousands of dollars)

	May 31, 2006			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
<u>ASSETS</u>				
Cash & cash equivalents	\$ 54,540	\$ 13,418	\$ 2,841	\$ 70,799
Student accounts receivable, net	9,532	--	--	9,532
Contributions, grants & other receivables	19,950	10,608	7,579	38,137
Prepaid expenses & other	8,186	7	--	8,193
Student loans receivable, net	9,096	--	5,349	14,445
Investments, at fair value	421,279	69,805	484,958	976,042
Property, plant & equipment, net of accumulated depreciation of \$223,731 & \$215,934 at May 31, 2006 & 2005, respectively	521,255	--	--	521,255
Total assets	\$ 1,043,838	\$ 93,838	\$ 500,727	\$ 1,638,403
<u>LIABILITIES & NET ASSETS</u>				
Liabilities				
Accounts payable	\$ 17,425	\$ 390	\$ 382	\$ 18,197
Salaries & payroll taxes payable	29,727	--	--	29,727
Deposits & deferred income	29,109	--	--	29,109
Annuities payable	--	1,065	4,667	5,732
Notes & bonds payable	301,704	--	--	301,704
Liability for interest rate swap	16,413	--	--	16,413
Federal student loan funds refundable	7,345	--	--	7,345
Total liabilities	401,723	1,455	5,049	408,227
Net Assets				
Unrestricted	1,877	--	--	1,877
Designated for operations	22,263	--	--	22,263
Restricted	--	8,162	6,251	14,413
Annuity & living trusts	--	13,430	21,956	35,386
Endowment	208,229	49,566	467,471	725,266
Board-designated endowment	135,643	9,259	--	144,902
Net invested in plant	274,103	11,966	--	286,069
Total net assets	642,115	92,383	495,678	1,230,176
Total liabilities & net assets	\$ 1,043,838	\$ 93,838	\$ 500,727	\$ 1,638,403

See accompanying notes to financial statements.

May 31, 2005			
<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
\$ 29,847	\$ 7,611	\$ 5,171	\$ 42,629
7,180	--	--	7,180
19,141	10,123	6,921	36,185
7,369	13	--	7,382
9,928	--	4,547	14,475
285,375	54,342	456,475	796,192
522,252	--	--	522,252
<u>\$ 881,092</u>	<u>\$ 72,089</u>	<u>\$ 473,114</u>	<u>\$ 1,426,295</u>
\$ 12,366	\$ 325	\$ 101	\$ 12,792
29,021	--	--	29,021
26,484	--	--	26,484
--	1,448	4,474	5,922
247,459	--	--	247,459
37,384	--	--	37,384
7,329	--	--	7,329
<u>360,043</u>	<u>1,773</u>	<u>4,575</u>	<u>366,391</u>
1,608	--	--	1,608
19,574	--	--	19,574
--	6,790	6,005	12,795
--	12,545	21,126	33,671
148,658	38,437	441,408	628,503
109,912	7,722	--	117,634
241,297	4,822	--	246,119
<u>521,049</u>	<u>70,316</u>	<u>468,539</u>	<u>1,059,904</u>
<u>\$ 881,092</u>	<u>\$ 72,089</u>	<u>\$ 473,114</u>	<u>\$ 1,426,295</u>

BAYLOR UNIVERSITY
Statements of Activities

For the Years Ended May 31, 2006 and 2005
(in thousands of dollars)

	Year Ended May 31, 2006		
	Unrestricted	Temporarily Restricted	Permanently Restricted
			Total
<u>REVENUES</u>			
Tuition & fees	\$ 286,798	\$ --	\$ --
Less scholarships	(86,349)	--	--
Net tuition & fees	200,449	--	--
Gifts, private grants & Baptist General Convention of Texas appropriation	13,155	14,961	13,514
Endowment & investment income	41,517	5,524	3,590
Realized gains (losses) on investments	9,519	(73)	896
Other sources	19,782	9,215	--
Auxiliary enterprises	44,795	--	--
Total revenues	329,217	29,627	18,000
Net assets released from restrictions	20,984	(20,829)	(155)
Total net revenues	350,201	8,798	17,845
<u>EXPENSES</u>			
Program expenses			
Instruction	148,719		
Academic support, research & public service	44,424		
Student activities & services	24,171		
Auxiliary enterprises	57,347		
Support expenses			
Institutional support	42,542		
Total expenses	317,203		
Increase (decrease) in net assets before other changes	32,998	8,798	17,845
<u>OTHER CHANGES</u>			
Unrealized gains on investments	67,486	11,815	7,654
Unrealized gain (loss) on interest rate swap	20,971	--	--
Loss on disposal of fixed assets	(598)	--	--
Change in value of split interest agreements - Present value adjustments	--	2,235	1,068
Terminated annuities	209	(781)	572
Total other changes	88,068	13,269	9,294
Increase in net assets	121,066	22,067	27,139
Net assets at beginning of year	521,049	70,316	468,539
Net assets at end of year	\$ 642,115	\$ 92,383	\$ 495,678

See accompanying notes to financial statements.

Year Ended May 31, 2005			
Unrestricted	Temporarily Restricted	Permanently Restricted	Total
\$ 253,948	\$ --	\$ --	\$ 253,948
(73,845)	--	--	(73,845)
180,103	--	--	180,103
11,994	5,830	13,880	31,704
36,581	4,990	2,014	43,585
106	91	1,426	1,623
18,875	10,526	--	29,401
41,114	--	--	41,114
288,773	21,437	17,320	327,530
21,920	(21,787)	(133)	--
310,693	(350)	17,187	327,530
143,969			143,969
42,169			42,169
23,220			23,220
51,222			51,222
43,548			43,548
304,128			304,128
6,565	(350)	17,187	23,402
44,882	6,948	2,211	54,041
(12,594)	--	--	(12,594)
(198)	--	--	(198)
--	341	1,126	1,467
--	--	--	--
32,090	7,289	3,337	42,716
38,655	6,939	20,524	66,118
482,394	63,377	448,015	993,786
\$ 521,049	\$ 70,316	\$ 468,539	\$ 1,059,904

BAYLOR UNIVERSITY
Statements of Cash Flows

For the Years Ended May 31, 2006 and 2005
(in thousands of dollars)

	Year Ended May 31, 2006	Year Ended May 31, 2005
<u>CASH FLOWS FROM OPERATING ACTIVITIES</u>		
Increase in Net Assets	\$ 170,272	\$ 66,118
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation	27,148	26,958
Loss on disposal of property & equipment	598	198
Fixed assets gifts-in-kind	--	(54)
Net realized & unrealized gains on investments	(97,297)	(55,664)
Unrealized loss (gain) on interest rate swap	(20,971)	12,594
Contributions restricted for permanent investment	(13,514)	(13,880)
Decrease (increase) in:		
Student accounts receivable	(2,352)	4,395
Contributions, grants & other receivables	(1,952)	448
Prepaid expenses & other	216	264
Increase (decrease) in:		
Accounts payable	5,405	(13,960)
Salaries & payroll taxes payable	706	5,392
Deposits & deferred income	2,625	(2,066)
Annuities payable	(190)	162
Net cash provided by operating activities	70,694	30,905
<u>CASH FLOWS FROM INVESTING ACTIVITIES</u>		
Student loans issued	(2,547)	(3,713)
Proceeds from collections of student loans	2,577	2,024
Proceeds from sales of investments	55,874	45,400
Purchases of investments	(138,427)	(44,051)
Proceeds from sale of property & equipment	--	400
Purchases of property, plant & equipment	(26,749)	(26,656)
Net cash used in investing activities	(109,272)	(26,596)
<u>CASH FLOWS FROM FINANCING ACTIVITIES</u>		
Contributions restricted for permanent investments:		
Endowment	13,241	11,619
Annuities & living trusts	273	2,261
Proceeds from issuance of long-term debt	63,500	--
Repayment of long-term debt	(9,255)	(8,979)
Debt issue costs	(1,027)	--
Increase in federal student loan funds refundable	16	75
Net cash provided by financing activities	66,748	4,976
Net increase in cash & cash equivalents	28,170	9,285
Cash & cash equivalents at beginning of year	42,629	33,344
Cash & cash equivalents at end of year	\$ 70,799	\$ 42,629

See accompanying notes to financial statements.

BAYLOR UNIVERSITY

NOTES TO FINANCIAL STATEMENTS

May 31, 2006 and 2005

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 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 \$7,567,000 and \$6,450,000 incurred by the University in 2006 and 2005, 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

BAYLOR UNIVERSITY

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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 & Cash Equivalents

Cash on deposit and all highly liquid financial instruments with maturities of six 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. 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 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 expended for operational needs. For the years ended May 31, 2006 and 2005, this dividend was based on 5% of the previous 48 months' average market value per unit of the BUF subject to a 3% minimum and a 6% maximum dividend rate increase from the previous year. The 3% minimum dividend rate increase was utilized for both years ended May 31, 2006 and 2005.

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, based on the Internal Revenue Service ("IRS") discount rate at the time of the original gift.

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

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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 2005 financial statements to conform to the 2006 presentation.

2. INVESTMENTS

The University's 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 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.

Cost and estimated fair value of investments as of May 31, 2006 and 2005, are as follows:

	<i>(in thousands of dollars)</i>			
	2006		2005	
	<u>Cost</u>	<u>Estimated Fair Value</u>	<u>Cost</u>	<u>Estimated Fair Value</u>
Investments:				
Short-term	\$ 4,034	\$ 5,525	\$ 14,394	\$ 19,601
Collateralized investment contract / short-term fixed income securities (bond proceeds)	62,888	62,986	6,903	6,903
Debt securities	62,025	85,244	63,392	81,539
Equity securities	348,808	499,148	349,742	463,795
Alternative assets	182,731	270,516	132,390	180,422
Real estate	8,031	16,905	11,490	21,703
Mineral rights	9,656	34,900	8,060	21,873
Other	<u>562</u>	<u>818</u>	<u>356</u>	<u>356</u>
Total investments	<u>\$ 678,735</u>	<u>\$ 976,042</u>	<u>\$ 586,727</u>	<u>\$ 796,192</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.

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. Bond proceeds consist of a collateralized investment contract of \$5,062,000 and \$6,903,000 and an account at Wells Capital Management of \$57,924,000 and \$0- as of May 31, 2006 and 2005, respectively. 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. The account at Wells Capital Management consists of short-term fixed income securities including corporate bonds and commercial paper. Alternative assets consist of distressed securities, venture capital, hedge funds and private equities.

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NOTES TO FINANCIAL STATEMENTS

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, at fair value, are managed by the following:

	<i>(in thousands of dollars)</i>	
	2006	2005
The University	\$ 785,455	\$ 624,285
BFT	154,406	138,691
Others	<u>36,181</u>	<u>33,216</u>
Total	<u>\$ 976,042</u>	<u>\$ 796,192</u>

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 7% of the BFT's total assets as of May 31, 2006 and 2005.

Investments include interests in split interest agreements. The fair values representing interests in split interest agreements are \$148,500,000 and \$138,276,000 as of May 31, 2006 and 2005, respectively.

Investment returns for the years ended May 31, 2006 and 2005, consist of the following:

	<i>(in thousands of dollars)</i>	
	2006	2005
Endowment & investment income	\$ 50,631	\$ 43,585
Realized gains on investments	10,342	1,623
Unrealized gains on investments	<u>86,955</u>	<u>54,041</u>
Total investment returns	<u>\$ 147,928</u>	<u>\$ 99,249</u>

The endowment & investment income reflected is net of investment expenses of \$6,217,000 and \$5,473,000 for the years ended May 31, 2006 and 2005, respectively.

3. PROPERTY, PLANT & EQUIPMENT

At May 31, 2006 and 2005, plant assets consist of:

	<i>(in thousands of dollars)</i>	
	2006	2005
Land	\$ 28,815	\$ 28,218
Buildings	547,679	537,382
Equipment	62,974	77,960
Other improvements	<u>95,804</u>	<u>91,464</u>
	735,272	735,024
Less accumulated depreciation	<u>(223,808)</u>	<u>(215,934)</u>
	511,464	519,090
Construction-in-progress	<u>9,791</u>	<u>3,162</u>
Property, plant & equipment, net	<u>\$ 521,255</u>	<u>\$ 522,252</u>

Depreciation expense was \$27,148,000 and \$26,958,000 for the years ended May 31, 2006 and 2005, respectively. Real and personal property were insured for \$1,300,000,000 and \$1,000,000,000 at May 31, 2006 and 2005, respectively. During the year ended May 31, 2006, the University conducted a physical inventory of all equipment and technology assets, resulting in a write-off of \$19,644,000 in equipment and related accumulated depreciation of \$19,125,000 (\$17,443,000 related to fully depreciated equipment and technology assets).

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NOTES TO FINANCIAL STATEMENTS

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, 2036 were \$301,704,000 and \$247,459,000 at May 31, 2006 and 2005, respectively. Interest payments on a cash basis totaled \$11,699,000 and \$11,396,000, and interest expense was \$11,376,000 and \$11,466,000 for the years ended May 31, 2006 and 2005, respectively. Interest expense totaling \$-0- and \$2,583,000 was capitalized to projects for the years ended May 31, 2006 and 2005, respectively. For the year ended May 31, 2005, earnings of \$280,000 on bond proceeds were utilized to offset interest capitalized.

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 issued an additional \$63,500,000 in tax-exempt revenue bonds through the Waco Education Finance Corporation in May, 2006. The University capitalized and is amortizing on a straight-line basis bond issue costs related to the Series 2002A, 2002B, 2002C and 2006 issues over the life of the bonds. As of May 31, 2006 and 2005, unamortized bond issue costs of \$4,557,000 and \$3,667,000, respectively, are included in prepaid expenses and other in the University's balance sheets. Amortization expense for issue costs was \$163,000 and \$162,000 for the years ended May 31, 2006 and 2005, respectively.

Notes & bonds payable at May 31, 2006 and 2005, consist of the following:

	<i>(in thousands of dollars)</i>	
	2006	2005
Non-interest bearing unsecured note payable to a foundation, due in annual installments beginning June 30, 2004 to June 30, 2013	\$ 4,000	\$ 4,500
Non-interest bearing unsecured note payable to a foundation, due in quarterly installments as repayments from loans to students are received	1,276	1,736
Unsecured note payable to a foundation, bearing interest at 5%, due in annual installments to May 15, 2006, interest only May 15, 2004	--	1,000
Non-interest bearing unsecured notes payable to a corporation, due in monthly installments through September 1, 2008	584	834
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	3,508	3,958
Non-interest bearing unsecured note payable to a private entity, due in annual installments through June 30, 2008	210	280
Secured note payable to a private entity (secured by property), bearing interest at 9.57%, due in monthly installments through July 1, 2006, with planned payment in full August 1, 2006	1,801	1,851
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	165,800	168,925
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, principal payable annually to February 1, 2032	50,050	53,200
Series 2002C Waco Education Finance Corporation Taxable SAVRS, bearing interest at the SAVRS rate for each 35-day auction rate period (4.90% and 3.10% at May 31, 2006 and 2005, respectively), principal payable annually to February 1, 2032	10,975	11,175
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, principal payable annually to February 1, 2036	<u>63,500</u>	<u>--</u>
Total Notes & Bonds Payable	<u>\$301,704</u>	<u>\$247,459</u>

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NOTES TO FINANCIAL STATEMENTS

The fair values of notes and bonds payable is not materially different from the book values as of May 31, 2006 and 2005.

Principal and interest on notes and bonds for the periods subsequent to May 31, 2006 are as follows:

	<i>(in thousands of dollars)</i>						
	2007	2008	2009	2010	2011	2012 and Thereafter	Total
Principal	\$ 11,056	\$ 7,790	\$ 7,988	\$ 7,778	\$ 7,997	\$ 259,095	\$ 301,704
Interest	13,083	12,700	12,386	12,058	11,714	145,415	207,356
Total	<u>\$ 24,139</u>	<u>\$ 20,490</u>	<u>\$ 20,374</u>	<u>\$ 19,836</u>	<u>\$ 19,711</u>	<u>\$ 404,510</u>	<u>\$ 509,060</u>

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 balance of \$165,800,000 as of May 31, 2006, for a fixed rate of 4.91% through February 1, 2032, to swap the University's Series 2002B variable rate demand bonds having a balance of \$50,050,000 as of May 31, 2006, for a synthetic fixed rate of 3.83% under a BMA/LIBOR-based structure through February 1, 2032, and to swap the University's Series 2006 variable rate demand bonds having a balance of \$63,500,000 as of May 31, 2006, for a synthetic fixed rate of 3.543% under a LIBOR-based structure through February 1, 2036. The University entered into these swap agreements to obtain fixed rate financing at the lowest available cost at the time of the transaction. The value of the swap instruments 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 swaps included in the University's balance sheets as a liability at May 31, 2006 and 2005, was \$16,413,000 and \$37,384,000, 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 \$20,971,000 as of May 31, 2006, and a loss of \$12,594,000 as of May 31, 2005.

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, 2006 and 2005, were \$9,386,000 and \$9,457,000, respectively.

7. 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.

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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 net assets or amortized as an expenditure over 20 years. The University chose to amortize the accumulated postretirement benefits over 20 years. The accrued post retirement benefit cost is included in salaries and payroll taxes payable in the University's balance sheets.

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

	<i>(in thousands of dollars)</i>	
	2006	2005
<u>Change in benefit obligation:</u>		
Measurement Date	5/31/2006	5/31/2005
Accumulated postretirement benefit obligation (APBO)		
at beginning of year	\$ 26,823	\$ 28,566
Service cost	907	1,001
Interest cost	1,568	1,819
Plan participants' contributions	1,079	979
Plan Amendment	5,691	--
Actuarial (gain)loss	(6,839)	(3,510)
Benefit payments	(2,177)	(2,032)
Accumulated postretirement benefit obligation		
at end of year	27,052	26,823
<u>Change in plan assets:</u>		
Fair value of plan assets at beginning of year	--	--
Actual return on plan assets	--	--
Employer contributions	1,098	1,053
Plan participants' contributions	1,079	979
Benefit payments	(2,177)	(2,032)
Fair value of plan assets at end of year	--	--
Funded status	(27,052)	(26,823)
Unrecognized transition obligation	1,916	2,190
Unrecognized prior service cost	5,369	--
Unrecognized net loss	3,651	10,883
Accrued postretirement benefit cost	\$ (16,116)	\$ (13,750)
<u>Weighted-average assumptions at measurement date</u>		
Discount rate	6.31%	5.50%
Health care cost trend rate (grading to 5% in 2015)	9.00%	9.50%

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	<i>(in thousands of dollars)</i>	
	Gross Benefit Payments	Gross Subsidy Receipts
Cash flows:	Net of Employee Contributions	
2007 Fiscal year	\$ 1,267	\$ 185
2008 Fiscal year	1,348	206
2009 Fiscal year	1,436	227
2010 Fiscal year	1,532	250
2011 Fiscal year	1,607	275
2012-2016 Fiscal years	9,579	1,920

Expected Employer Contributions:

2007 Fiscal year	1,082
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<u>Components of net periodic postretirement benefit cost:</u>	6/1/05-5/31/06	6/1/04-5/31/05
Measurement Date	5/31/2005	5/31/2004
Service cost	\$ 907	\$ 1,001
Interest cost	1,568	1,819
Amortization of:		
Transition obligation	274	274
Prior service cost	321	--
Actuarial loss	393	962
Net postretirement benefit cost	<u>\$ 3,463</u>	<u>\$ 4,056</u>

Weighted-average assumptions for net periodic postretirement benefit cost:

Discount rate	5.50%	6.50%
Health care cost trend rate (grading to 5% in 2011)	9.50%	10.25%

Other Information:

1% increase in trend rates		
Effect on service + interest cost	\$ 480	\$ 394
Effect on APBO	3,454	3,490
1% decrease in trend rates		
Effect on service + interest cost	\$ (371)	\$ (313)
Effect on APBO	(2,769)	(2,841)

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.

The University reflected the effects of the Act on the plan during the fiscal year ended May 31, 2006. The increase in the APBO as of December 1, 2005, resulting from the changes in the plan to qualify for the federal retiree drug subsidy, is \$12,688,000.

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The increase in the measurement of net periodic postretirement benefit cost for the fiscal year ended May 31, 2006 due to the effect of the subsidy is as follows:

	<i>(in thousands of dollars)</i>
Service cost	\$ 345
Interest cost	347
Prior service cost amortization	717
Actuarial (gain)/loss amortization	--
Total increase	<u>\$ 1,409</u>

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 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 \$24,647,000 and \$44,775,000 as of May 31, 2006 and 2005, respectively. Payments on these intents to give are due in varying periods.

As of May 31, 2006 and 2005, unconditional promises to give consist of the following:

	<i>(in thousands of dollars)</i>	
	2006	2005
Endowment funds	\$ 500	\$ 200
Building projects		
Due in 1 year	1,023	774
Due in 1 to 5 years	865	1,431
Split interest agreements	24,206	22,167
Less: Present value adjustment	(10,104)	(9,161)
Total contributions receivable	<u>\$ 16,490</u>	<u>\$ 15,411</u>

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

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NOTES TO FINANCIAL STATEMENTS

11. COMMITMENTS AND CONTINGENCIES

Capital Expenditures

The University is contractually obligated for amounts aggregating a maximum of approximately \$50,082,000 and \$6,175,000 at May 31, 2006 and 2005, respectively. Such obligations relate primarily to capital projects.

Leases

The University incurred \$195,000 and \$198,000 in operating lease expenses for facilities and equipment in the fiscal years ended May 31, 2006 and 2005, respectively. As of May 31, 2006, the University has lease commitments for future periods totaling approximately \$250,000. Of these commitments, \$142,000, \$86,000 and \$22,000 are due in the fiscal years ending 2007 through 2009, respectively.

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 \$151,656,000 and \$103,070,000 at May 31, 2006 and 2005, respectively, which are expected to be called over the next five years.

Conditional Asset Retirement Obligations

In March 2005, the Financial Accounting Standards Boards issued Interpretation No. 47 ("FIN 47"), *Accounting for Conditional Asset Retirement Obligations*. Under FIN 47, organizations must accrue for costs related to legal obligations to perform certain activities in connection with the retirement, disposal or abandonment of assets. The University has identified asbestos abatement as a conditional asset retirement obligation. Asbestos abatement is being estimated using site-specific surveys, where available, and a per square foot estimate where surveys are not available. Other conditional asset retirement obligations may exist due to other regulated substances. As of May 31, 2006, the University has not accrued the estimated costs of these conditional asset retirement obligations because presently the range of time over which the University may retire, dispose or perform major renovations to assets containing these substances cannot be reasonably estimated.

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.