



**William Marsh Rice
University**
Consolidated Financial Statements
June 30, 2010 and 2009

William Marsh Rice University
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June 30, 2010 and 2009

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Report of Independent Auditors

To the Board of Trustees of
William Marsh Rice University

In our opinion, the accompanying consolidated statement of financial position and the related consolidated statements of activities and cash flows present fairly, in all material respects, the financial position of William Marsh Rice University at June 30, 2010, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. 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 audit. The prior year summarized comparative information has been derived from the University's 2009 financial statements. In our report dated October 29, 2009, we expressed an unqualified opinion on those financial statements. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

October 28, 2010

William Marsh Rice University
Consolidated Statements of Financial Position
As of June 30, 2010 and 2009

<i>(in thousands of dollars)</i>	<u>2010</u>	<u>2009</u>
Assets		
Cash and cash equivalents	\$ 7,541	\$ 4,294
Accounts receivable and other assets, net	68,377	47,164
Pledges receivable, net	131,246	155,407
Investments	4,225,453	3,989,875
Property and equipment, net	1,190,243	1,070,788
Total assets	<u>\$ 5,612,860</u>	<u>\$ 5,267,528</u>
Liabilities		
Accounts payable and other liabilities	\$ 100,131	\$ 100,146
Notes and bonds payable	873,044	726,185
Actuarial liability for annuities payable	88,205	79,433
Government refundable advances	7,061	6,974
Total liabilities	<u>1,068,441</u>	<u>912,738</u>
Net assets		
Unrestricted net assets	2,217,991	2,157,487
Temporarily restricted net assets	1,372,717	1,268,152
Permanently restricted net assets	953,711	929,151
Total net assets	<u>4,544,419</u>	<u>4,354,790</u>
Total liabilities and net assets	<u>\$ 5,612,860</u>	<u>\$ 5,267,528</u>

The accompanying notes are an integral part of these financial statements.

William Marsh Rice University
Consolidated Statement of Activities
For the Year Ended June 30, 2010
With Summarized Financial Information for the Year Ended June 30, 2009

<i>(in thousands of dollars)</i>	2010			2009
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Operating revenues				
Investment returns distributed for operations	\$ 103,648	\$ 117,199	\$ -	\$ 220,847
Student tuition and fees, net	98,107	-	-	98,107
Grants and contracts	102,235	-	-	102,235
Gifts and pledges	22,896	27,416	-	50,312
Gifts and trusts released from restrictions	123,951	(123,951)	-	-
Auxiliary enterprises	33,240	-	-	33,240
Other revenues	15,257	-	-	15,257
Total operating revenues	499,133	20,664	-	519,797
Operating expenses				
Educational and general activities	453,193	-	-	453,193
Auxiliary enterprise expenditures	45,200	-	-	45,200
Total operating expenses	498,393	-	-	498,393
Net operating income	740	20,664	-	21,404
Nonoperating changes				
Gifts and pledges for property and endowment	-	13,783	15,217	29,000
Investment returns, reduced by operating distribution above	47,216	88,841	14,240	150,297
Net assets released from restrictions	18,381	(18,418)	36	-
Change in liabilities due under life-income agreements	-	(307)	(4,955)	(5,262)
Other nonoperating changes	(5,833)	-	23	(5,810)
Net nonoperating changes	59,764	83,901	24,560	168,225
Net increase (decrease) in net assets	60,504	104,565	24,560	189,629
Net assets				
Beginning of year	2,157,487	1,288,152	929,151	4,364,790
End of year	\$ 2,217,991	\$ 1,372,717	\$ 953,711	\$ 4,544,419

The accompanying notes are an integral part of these financial statements.

William Marsh Rice University
Consolidated Statements of Cash Flows
For the Years Ended June 30, 2010 and 2009

<i>(in thousands of dollars)</i>	<u>2010</u>	<u>2009</u>
Cash flows from operating activities		
Net increase (decrease) in net assets	\$ 189,829	\$ (1,026,978)
Adjustments to reconcile increase (decrease) in net assets to net cash used in operating activities		
Depreciation of property and equipment	55,811	44,919
Loss on disposal of property and equipment	24	2,613
Net realized and unrealized investment (gains) losses	(333,072)	938,295
Contributions restricted for long term purposes and non-cash contributions	(56,531)	(88,471)
Actuarial change in life-income agreements	5,262	(22,782)
Change in fair value of interest rate swap	6,341	5,902
Change in		
Accounts receivable and other assets	(10,779)	(914)
Pledges receivable for current purposes	(6,787)	17,768
Accounts payable and accrued liabilities	(11,623)	5,515
Net cash used in operating activities	<u>(161,725)</u>	<u>(102,133)</u>
Cash flows from investing activities		
Proceeds from sales and maturities of investments	732,602	970,375
Purchases of investments	(570,931)	(663,429)
Purchases of property and equipment	(177,808)	(272,535)
Net cash provided by (used in) investing activities	<u>(16,137)</u>	<u>34,412</u>
Cash flows from financing activities		
Contributions restricted for long term purposes		
Endowment	17,821	8,584
Trusts and other	(277)	541
Property	16,619	13,859
Tax-exempt debt activity		
Proceeds from issuance of tax-exempt debt	140,514	-
Principal payment of tax-exempt debt	(2,055)	-
Commercial paper activity		
Proceeds from issuance of commercial paper	10,000	45,000
Payment of outstanding commercial paper	(1,600)	-
Change in government refundable advances	87	64
Net cash provided by financing activities	<u>181,109</u>	<u>68,048</u>
Net increase in cash and cash equivalents	<u>3,247</u>	<u>327</u>
Cash and cash equivalents		
Beginning of year	<u>4,294</u>	<u>3,967</u>
End of year	<u>\$ 7,541</u>	<u>\$ 4,294</u>

Non-cash investing activities: The University had open accounts payable and accruals at June 30, 2010 of \$16,126,000 and at June 30, 2009 of \$27,706,000, related to property, plant and equipment purchases.

The accompanying notes are an integral part of these financial statements.

William Marsh Rice University
Notes to Consolidated Financial Statements
For the Year Ended June 30, 2010 with Summarized Financial Information for the
Year Ended June 30, 2009

1. Basis of Presentation and Summary of Significant Accounting Policies

Basis of Presentation

William Marsh Rice University (the "University") is a Texas not-for-profit corporation that operates a private research university in Houston, Texas. The consolidated financial statements of the University as of June 30, 2010, and for the year then ended, have been prepared in accordance with accounting principles generally accepted in the United States of America. Accordingly, the accompanying consolidated financial statements have been prepared on the accrual basis of accounting and include the accounts of the University and all wholly-owned subsidiaries. All material transactions between the University and its subsidiaries have been eliminated.

The financial statements include certain prior year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with accounting principles generally accepted in the United States of America. Accordingly, such information should be read in conjunction with the University's financial statements for the year ended June 30, 2009, from which the summarized information was derived. Certain reclassifications of 2009 information have been made to conform to the 2010 presentation.

Net Asset Categories

Standards for external financial reporting by not-for-profit organizations require that resources be classified for reporting purposes into three net asset categories according to donor-imposed restrictions. A description of the University's three net asset categories follows:

a. Unrestricted net assets and related activity include the following:

- (1) All revenues traditionally classified as unrestricted resources of the University, including tuition and fees, unrestricted gifts, investment returns on unrestricted funds designated to function as endowment, recovery of facilities and administrative costs from grants and contracts, and auxiliary enterprise revenues.
- (2) Revenues related to sponsored research and other sponsored program agreements, which are considered exchange transactions.
- (3) Unrestricted funds functioning as endowment and related investment returns.
- (4) Gifts with donor imposed restrictions, if the restriction will be met within the current fiscal year of the University.
- (5) Investments in plant assets.
- (6) All expenses of the University.

b. Temporarily restricted net assets include investment returns from unrestricted endowments and from restricted endowments and gifts for which donor-imposed restrictions have not been met. The restriction on unrestricted endowment returns (income and realized and unrealized gains and losses) is released when appropriations are distributed for use in the current fiscal year. The category also includes pledges receivable and life-income gifts for which the ultimate purpose of the proceeds is not permanently restricted.

William Marsh Rice University
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For the Year Ended June 30, 2010 with Summarized Financial Information for the
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- c. Permanently restricted net assets include gifts, trusts and pledges on which donors have imposed the restriction that the corpus be maintained in perpetuity and only the investment returns be made available for program operations. In the case of trusts, gains and losses are added to the gift amount. Gifts restricted by donors to provide loans to students are also included in permanently restricted net assets.

The terms of certain gifts of real property made by the founder of the University provided that all returns realized from these properties are to be invested to generate income to be used for University purposes. Changes in the market value of these specific properties, whether gains or losses, are recorded as permanently restricted as required by the donor.

Expirations of temporary restrictions on net assets are reported as reclassifications between the applicable classes of net assets. Donor required matching from University funds and donor release or clarification of restrictions are also included in this category.

Texas adopted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) in September, 2007, and the standard was effective for fiscal years ending after December 15, 2008. The Board of Trustees interpreted UPMIFA as requiring the preservation of the original gift as of the gift date of the donor restricted endowment funds absent explicit donor stipulation to the contrary. As a result of this interpretation, the University classifies as permanently restricted net assets, (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor restricted endowment fund that is not classified as permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the University in a manner consistent with the standard of prudence prescribed by UPMIFA (Note 5).

Contributions

Contributions, including unconditional promises to give and irrevocable trusts held by others under which the University is the beneficiary, are recognized as revenues in the period received or promised. Contributions restricted for the acquisition of land, buildings and equipment are reported as temporarily restricted revenues. These contributions are reclassified to unrestricted net assets when the assets are placed in service. Promises to give that are subject to donor-imposed stipulations that the corpus be maintained in perpetuity are recognized as increases in permanently restricted net assets.

Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Contributions of assets other than cash are reported at their estimated fair value at the date of gift. Contributions scheduled to be received after one year are discounted using a market rate (Note 3). Amortization of the discount is recorded as contribution revenue.

Operating and Nonoperating Activities

The consolidated statement of activities reports the change in net assets from the University's operating and nonoperating activities. Operating activities exclude (a) gifts and pledges for property and endowment (including annuity and life-income trusts), (b) release from restrictions of contributions restricted for the acquisition of property and equipment, (c) donor release of restrictions from permanently restricted net assets, (d) endowment returns net of the University's operating needs as defined by University spending policy (Note 5), (e) actuarial adjustments of annuities payable and (f) changes in fair value of swap agreements (Note 6 and Note 9).

Willam Marsh Rice University
Notes to Consolidated Financial Statements
For the Year Ended June 30, 2010 with Summarized Financial Information for the
Year Ended June 30, 2009

Cash and Cash Equivalents

The University considers all highly liquid financial instruments with an original maturity of 90 days or less to be cash and cash equivalents, except those amounts assigned to its investment managers and unspent commercial paper proceeds, which are classified as investments.

Investments and Other Financial Instruments

Investments are made within guidelines authorized by the University's Board of Trustees. Investments are initially recorded at cost at date of acquisition or fair value at date of donation in the case of gifts. Ownership of marketable securities is recognized as of the trade date. Marketable securities transactions that have not settled are recognized as accounts receivable or accounts payable until the settlement date. Endowment returns are calculated net of internal and external investment management expenses.

Investments are stated at fair value. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

The estimated fair value of investments is based on quoted market prices, except for alternative investments for which quoted market prices are not available. The University has adopted a hierarchy of valuation inputs based on the extent to which the inputs are observable in the marketplace. Observable inputs reflect market data and unobservable inputs reflect the University's own assumptions about how market participants would value an asset or liability based on the best information available.

The following describes the hierarchy of inputs used to measure fair value and the primary valuation methodologies used by the University for financial instruments measured at fair value on a recurring basis (Note 6). The three levels of inputs are as follows:

- Level 1 - Quoted prices in active markets for identical assets or liabilities.
- Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the same term of the assets or liabilities.
- Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

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For the Year Ended June 30, 2010 with Summarized Financial Information for the
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The estimated fair value of certain alternative investments, such as private equity and other limited partnership interests, is based on valuations provided by the general partners or partnership valuation committees. Such valuations consider variables such as financial performance of investments, recent sale prices of similar investments and other pertinent information. The University reviews and evaluates the values, the valuation methods and assumptions provided by the investment managers and used in determining the fair value. Because alternative investments are not readily marketable, their estimated fair 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. These differences could be material.

The fair value of real estate, timber, oil and gas and other investments is estimated by professional appraisers or University management.

Derivative financial instruments are recorded on the statement of financial position as either an asset or liability measured at its fair value as of the reporting date. Derivative financial instruments consist of interest rate swaps and energy hedge agreements. Changes in the fair value of these derivatives are recognized in the statement of activities.

The University's investments are exposed to a number of risks including interest rate, market, and credit risks. Due to the level of risk exposure, it is possible that changes in the valuation of these investments may occur in the near term and that such changes could be material.

Property and Equipment

Educational property is stated at cost for purchased assets and fair market value at the date of donation in the case of gifts. Interest expense incurred during the period of construction of an asset for University use is capitalized until that asset is substantially completed and ready for use. The University depreciates its educational property assets (excluding works of art, which are not depreciated) using the straight-line method over their estimated useful lives. Repairs and maintenance of property and equipment are expensed as incurred. Equipment is removed from the records at the time of disposal.

Asset Retirement Obligations

The University recognizes asset retirement obligations (AROs) that are conditional on a future event, such as the legal obligation to safely dispose of asbestos when a building is remodeled or demolished. The University measures conditional AROs at estimated fair value using a probability-weighted, discounted cash flow model with multiple scenarios, if applicable. The present value of weighted, discounted cash flows is calculated annually using credit-adjusted, risk-free rates applicable to the University in order to determine the estimated fair value of the conditional AROs.

Life-Income Agreements

Life-income agreements include charitable remainder trusts and gift annuities. Charitable remainder trusts hold donated assets for which the University's subsidiary acts as trustee and periodically pays specified amounts to the designated beneficiaries. Generally, beneficiary payments are a fixed amount for annuity trusts and a fixed percentage of the fair market value of the trust assets or based on income earned for other charitable remainder trusts. At a date specified in each gift instrument, usually the beneficiary's date of death, ownership of the trust assets will transfer to the University and the beneficiary payments will cease. The University also enters into gift annuity agreements, which require that the University take ownership of the assets at the date of gift with an obligation to periodically pay specified amounts to designated beneficiaries for their lifetimes. Assets held in life-income trusts and those assets associated with

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gift annuities are included in investments. Contribution revenues are recognized at the date the trusts or gift annuities are established. Liabilities are recorded at the same time using actuarial tables established by the Internal Revenue Service and discounted according to the risk-free rate at the time of the gift. Discount rates range from 4% to 6%. The liability represents the present value of the estimated future payments to be made to the beneficiaries. The liabilities are adjusted annually for changes in the value of the assets and actuarial changes, which impact the estimates of future payments.

Government refundable advances

The University participates in the Perkins revolving loan program, which is funded principally by advances from the federal government. These advances are refundable to the federal government if the program is terminated or if the University ceases to participate in the program.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and disclosure of contingent assets and liabilities. Actual results could differ from these estimates.

Tax Status

The University is exempt from federal income tax to the extent provided under Section 501(c)(3) of the Internal Revenue Code. The Internal Revenue Service (IRS) issued a determination letter in January, 1938 that recognized the University as exempt from federal income tax under section 501(c)(3). The IRS confirmed in 2008 that this exemption still applies.

The University has ten wholly-owned subsidiary corporations that are included in the consolidated financial statements. Seven of these subsidiary corporations are exempt from federal income taxes under 501(c)(2), one is exempt under 501(c)(3), and two are subject to taxation. The University is classified as an organization that is not a private foundation under section 509(a) of the Internal Revenue Code because it is described in sections 509(a)(1) and 170(b)(1)(A)(ii) and, as such, gifts to the University qualify for deduction as charitable contributions. The University and its subsidiary corporations that are exempt from federal income tax are required to pay federal income tax on unrelated business income. The University and its subsidiary corporations did not have any material income tax liabilities for the years ended June 30, 2010 and 2009. The University has no financial reporting requirements for uncertain tax positions for the years ended June 30, 2010 and 2009.

Subsequent Events

For the year ended June 30, 2010, the University evaluated subsequent events from July 1, 2010 to October 28, 2010, the date these financial statements were issued.

William Marsh Rice University
Notes to Consolidated Financial Statements
For the Year Ended June 30, 2010 with Summarized Financial Information for the
Year Ended June 30, 2009

2. Accounts Receivable and Other Assets

Accounts receivable and other assets of the University at June 30, 2010 and 2009, were as follows:

(in thousands of dollars)

	<u>2010</u>	<u>2009</u>
Unsettled investment sales	\$ 5,372	\$ 4,938
Investment income receivable	4,591	4,815
Student loans receivable, net of allowance of \$1,286 in 2010 and \$1,267 in 2009	8,574	9,066
Inventory, prepaid expenses and other assets	20,656	8,115
Sponsored agreements receivable	14,687	13,376
Other accounts receivable	4,497	6,854
Total accounts receivable and other assets	\$ 58,377	\$ 47,164

3. Pledges Receivable

Unconditional promises to give are included in the consolidated financial statements as pledges receivable and revenue of the appropriate net asset category. Multi-year pledges are recorded after discounting to the present value of expected future cash flows. Unconditional promises to give at June 30, 2010 and 2009, are expected to be realized in the following periods:

(in thousands of dollars)

	<u>2010</u>	<u>2009</u>
In one year or less	\$ 26,112	\$ 58,585
Between one year and five years	86,113	75,493
More than five years	49,097	54,044
Less: Discount to net present value	(23,623)	(25,190)
Less: Allowance for uncollectible pledges	(6,453)	(7,525)
	<u>\$ 131,246</u>	<u>\$ 155,407</u>

Pledges receivable at June 30, 2010 and 2009, had the following restrictions:

(in thousands of dollars)

	<u>2010</u>	<u>2009</u>
Restricted for long-term investment	\$ 55,642	\$ 75,443
Buildings	49,107	63,459
Support of University programs and activities	56,573	49,220
Less: Discount to net present value	(23,623)	(25,190)
Less: Allowance for uncollectible pledges	(6,453)	(7,525)
	<u>\$ 131,246</u>	<u>\$ 155,407</u>

Discount rates ranging from 2% to 6% are used to discount pledges. A reserve rate of 4% is used for the allowance for uncollectible pledges. The reserve rate is reviewed periodically to ensure adequate provision for uncollectible amounts.

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During fiscal 2008, the University received a conditional pledge towards term and permanent endowments to support the activities of an academic center. Up to \$9,000,000 of this pledge remains conditional and will be recognized as contribution revenue in the years in which the conditions are met.

4. Investments

Investments at June 30, 2010 and 2009, were as follows:

(In thousands of dollars)

	<u>2010</u>	<u>2009</u>
Repurchase agreements	\$ -	\$ 74,336
Fixed income securities	803,031	628,904
Equity securities	1,282,682	1,371,880
Limited partnerships	1,856,462	1,614,776
Real estate, oil and gas, and other	<u>283,278</u>	<u>299,979</u>
	<u>\$ 4,225,453</u>	<u>\$ 3,989,875</u>

The table above includes annuity and life income fund assets of \$131,948,000 and \$122,950,000 as of June 30, 2010 and 2009, respectively. The repurchase agreements included in the above table represent unspent bond proceeds that were used to fund project expenditures in 2010 (Note 9).

The following table presents investment income and net gains (losses) for the year ended June 30, 2010 by net asset classification, with summarized information for the year ended June 30, 2009:

<i>(in thousands of dollars)</i>	<u>2010</u>			<u>2009</u>	
	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>	<u>Total</u>
Investment earnings	\$ 4,291	\$ 29,952	\$ 3,830	\$ 38,073	\$ 68,235
Net gains (losses) on investments	<u>148,573</u>	<u>178,098</u>	<u>10,410</u>	<u>333,071</u>	<u>(838,295)</u>
Total investment gains (losses) and earnings	150,864	208,040	14,240	371,144	(870,060)
Less: Investment returns distributed for operations	<u>(103,648)</u>	<u>(117,199)</u>	<u>-</u>	<u>(220,847)</u>	<u>(215,586)</u>
Investments returns, reduced by operating distribution	<u>\$ 47,216</u>	<u>\$ 88,841</u>	<u>\$ 14,240</u>	<u>\$ 150,297</u>	<u>\$ 1,085,848</u>

Investment earnings are presented net of internal and external investment management expenses of \$43,967,000 and \$44,740,000 in 2010 and 2009, respectively.

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For the Year Ended June 30, 2010 with Summarized Financial Information for the
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5. Endowments

The University's endowment consists of approximately 1,400 individual donor restricted endowment funds and approximately 100 funds designated by the Board of Trustees to function as endowments. The net assets associated with endowment funds, including funds designated by the Board of Trustees to function as endowments, are classified and reported based on the existence or absence of donor imposed restrictions.

The following table presents endowment net asset composition by type of fund for the year ended June 30, 2010, with summarized information for the year ended June 30, 2009:

<i>(In thousands of dollars)</i>	2010			2009	
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	Total
Donor restricted endowment funds	\$ (2,237)	\$ 1,207,836	\$ 935,060	\$ 2,140,659	\$ 2,019,891
Board designated endowment funds	1,694,033	1,031	-	1,695,064	1,645,376
Total endowment funds	\$ 1,691,796	\$ 1,208,867	\$ 935,060	\$ 3,835,723	\$ 3,665,267

The Board of Trustees of the University has interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the original gift as of the gift date of the donor restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the University classifies as permanently restricted net assets, (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument. The remaining portion of the donor restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the University in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the University considers the following factors in making a determination to appropriate or accumulate endowment funds:

- (1) The duration and preservation of the fund
- (2) The purposes of the University and the donor restricted endowment fund
- (3) General economic conditions
- (4) The possible effect of inflation and deflation
- (5) The expected total return from income and the appreciation of investments
- (6) Other resources of the University
- (7) The investment policies of the University

Endowment Investment Policies

The University has adopted endowment investment policies that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain, and, if possible, enhance the purchasing power of endowment assets. The University has a diversified approach to management of the endowment investment portfolio. By diversifying among asset classes and rebalancing toward policy target allocations, the University strives to manage and maintain the risk profile implied by the policy targets adopted by the board.

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To achieve its long-term return objectives, the University relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized gains) and current yield (interest and dividends). The University's diversified asset allocation places greater emphasis on equity based investments to achieve its long-term objectives within prudent risk and liquidity constraints. The long-term investment objectives of the endowment are to attain an average annual real total return in excess of endowment spending and to outperform various strategic policy and comparable industry universe benchmarks over the long term.

Endowment Spending Allocation and Relationship of Spending Policy to Investment Objectives

The Board of Trustees of the University approves the appropriation of endowment funds for expenditure. In establishing a distribution policy, the Board of Trustees considered a number of factors, including the expected long term investment rate of return on the endowment. Accordingly, over the long term, the University expects the current spending policy to allow its endowment to grow, consistent with its intention to maintain the purchasing power of the endowment assets while providing a relatively predictable and stable (in real terms) stream of earnings for current use. Under the University's endowment earnings distribution policy, endowment returns, net of operating distributions, are reinvested in the investment pool as temporarily restricted net assets functioning as endowment.

Endowment Funds with Deficits

From time to time, the fair value of assets associated with individual donor restricted endowment funds may fall below the value of the initial and subsequent donor gift amounts (deficit). These deficits result when unfavorable market fluctuations occur shortly after the investment of newly established endowments. Deficits of this type in donor restricted endowments totaled \$2,237,000 as of June 30, 2010 and \$6,599,000 as of June 30, 2009. Donor restricted endowment deficits are classified as a reduction of unrestricted net assets in the year they occur. In fiscal 2010, \$4,362,000 was returned to unrestricted net assets due to the reduction in deficits within donor restricted endowments.

Changes in endowment net assets for the year ended June 30, 2010 with summarized information for the year ended June 30, 2009 were:

<i>(In thousands of dollars)</i>	2010			2009	
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	Total
Endowment net assets, beginning of year	\$ 1,837,773	\$ 1,113,917	\$ 913,577	\$ 3,865,267	\$ 4,866,434
Investment returns					
Investment income	4,390	30,846	5,511	\$ 40,747	70,112
Net gains (losses) (realized and unrealized)	146,573	172,481	(78)	318,976	(809,231)
Total investment returns	150,963	203,327	5,433	359,723	(839,119)
Contributions	-	12,708	14,252	26,960	41,111
Appropriation of endowment assets for expenditure	(103,746)	(117,131)	-	(220,877)	(214,859)
Other Changes					
Transfers to create board designated endowment funds	2,444	-	-	2,444	11,542
Donor designation	-	-	1,798	1,798	4,714
Other Transfers	-	408	-	408	5,244
Transfer to unrestricted net assets	4,362	(4,362)	-	-	-
Endowment net assets, end of year	\$ 1,891,798	\$ 1,208,857	\$ 835,060	\$ 3,935,722	\$ 3,865,267

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6. Financial Instruments

The following table presents the financial instruments carried at fair value as of June 30, 2010, by category on the statement of financial position in accordance with the valuation hierarchy defined in Note 1:

<i>(in thousands of dollars)</i>	2010			2009
	Level 1	Level 2	Level 3	Total
Investments				
Repurchase agreements	\$ -	\$ -	\$ -	\$ 74,336
Fixed income securities	226,491	574,540	-	803,031
Equity securities	591,608	691,074	-	1,282,682
Limited partnerships	-	480,213	1,376,249	1,856,462
Real estate, oil and gas and other	10,827	-	272,451	283,278
Total investments at fair value	\$ 830,926	\$ 1,745,827	\$ 1,648,700	\$ 3,989,875
Swaps payable	\$ -	\$ -	\$ (15,874)	\$ (9,533)

The following tables present the changes in amounts included in the statement of financial position for financial instruments classified by the University within Level 3:

Assets

<i>(in thousands of dollars)</i>	Limited	Real Estate	2010	2009
	Partnerships	Oil and Gas, Other	Total	Total
Fair value July 1, 2009	\$ 1,359,629	\$ 290,771	\$ 1,650,400	\$ 2,190,812
Realized gains (losses)	(15,813)	-	(15,813)	43,933
Unrealized gains(losses)	65,120	(17,721)	47,399	(574,943)
Capital calls, distributions and other	50,605	(599)	50,006	(9,202)
Transfers In/(Out)	(83,292)	-	(83,292)	-
Fair value June 30, 2010	\$ 1,376,249	\$ 272,451	\$ 1,648,700	\$ 1,650,400

Liabilities

<i>(in thousands of dollars)</i>	2010 Swap	2009 Swap
	Agreements	Agreements
Fair value July 1, 2009	\$ 9,533	\$ 3,631
Unrealized losses	5,495	5,902
New agreement	846	-
Fair value June 30, 2010	\$ 15,874	\$ 9,533

Transfers out of level 3 for assets include five hedge fund investments that were reclassified to level 2 as redemption was made available as of June 30, 2010. The new agreement shown in liabilities is an energy hedge agreement.

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Limited partnership investments held by the University may be subject to restrictions that limit (i) the University's ability to redeem/withdraw capital from such investments during a specified period of time subsequent to the University's investment of capital in such funds and/or (ii) the amount of capital that investors may redeem/withdraw as of given redemption/withdrawal dates. Capital available for redemption/withdrawal may also be subject to redemption/withdrawal charges and may or may not include capital attributable to the University's participation in illiquid investments and/or designated investments held by the investments from which the University makes redemption/withdrawals. These investments generally limit redemptions to monthly, quarterly, semi-annually, annually or longer, at fair value, and require between 30 and 90 days' prior written notice, limiting the University's ability to respond quickly to changes in market conditions.

The University entered into agreements to hedge the cost of natural gas with a final termination of March 2012. The fair value of the agreements is the estimated amount that the University would pay or receive to terminate these contracts as of June 30, 2010. The estimated fair value of these arrangements was a liability of \$846,000 as of June 30, 2010. The change in value is reported as other nonoperating expense for 2010 on the Consolidated Statement of Activities. Interest rate swap agreements relate to outstanding debt (Note 9).

The University has various sources of internal liquidity at its disposal, including cash, cash equivalents and marketable debt and equity securities. At June 30, 2010, management estimates that it could have liquidated approximately \$2.8 billion (unaudited) within a one year period.

7. Property and Equipment

Property and equipment of educational plant at June 30, 2010 and 2009, were as follows:

<i>(In thousands of dollars)</i>	Estimated Useful Lives (Years)	2010	2009
Land	0	\$ 23,786	\$ 23,786
Buildings and improvements	20-50	1,206,892	791,616
Equipment, furniture and library books	2-20	340,902	310,529
Construction in progress	0	84,825	356,269
Less: Accumulated depreciation		<u>(466,161)</u>	<u>(411,405)</u>
		\$ 1,190,243	\$ 1,070,788

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8. Accounts Payable and Other Liabilities

Accounts payable and other liabilities of the University at June 30, 2010 and 2009, were as follows:

(in thousands of dollars)

	<u>2010</u>	<u>2009</u>
Unsettled investment purchases and advances	\$ 17,885	\$ 1,038
Vendor accounts payable	22,895	38,974
Accrued payroll and employee benefits	13,772	13,069
Sponsored agreements unearned income	18,590	16,227
Conditional asset retirement obligations	5,244	5,547
Conditional pledge advances	-	8,252
Swap agreements	15,874	9,533
Other liabilities	5,871	7,506
Total accounts payable and other liabilities	\$ 100,131	\$ 100,146

9. Notes and Bonds Payable

Notes and bonds payable of the University at June 30, 2010 and 2009, were as follows:

(in thousands of dollars)

	<u>2010</u>	<u>2009</u>
City of Houston Higher Education Finance Corporation (CHHEFC)		
Tax-exempt revenue bonds, Series 2010A & 2010B, maturing 2031 through 2048, with an average coupon of 5% per annum payable semiannually for Series 2010A and an average rate of interest at June 30, 2010 of 0.21% per annum payable monthly for Series 2010B	\$ 139,887	\$ -
Tax-exempt revenue bonds, Series 2008A & 2008B, maturing 2039 through 2048, with an average rate of interest at June 30, 2010, of 0.10% (0.22% at June 30, 2009) payable daily	200,000	199,373
Tax-exempt revenue bonds, Series 2007A & 2007B, maturing 2010 through 2047, with an average coupon of 4.75% per annum payable semiannually	312,577	314,632
Tax-exempt revenue refunding bonds, Series 2006A & 2006B, maturing 2023 through 2029, with an average rate of interest at June 30, 2010 of 0.23% (0.24% at June 30, 2009) per annum payable monthly	147,180	147,180
Tax-exempt commercial paper notes, Series A, with interest ranging from 0.28% to 0.35% at June 30, 2010 (0.35% to 0.55% at June 30, 2009) per annum payable upon maturity	73,400	65,000
	<u>\$ 873,044</u>	<u>\$ 726,185</u>

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The University incurred interest expense, net of interest earned, of approximately \$22,721,000 and \$18,819,000 in 2010 and 2009, respectively. Of these amount, interest expense of \$22,112,000 and \$10,889,000 was charged to operations and interest expense of \$809,000 and \$7,930,000 was capitalized in 2010 and 2009 respectively. The University made interest payments of approximately \$22,995,000 and \$23,737,000 in 2010 and 2009, respectively.

Tax-Exempt Revenue Bonds

Series 2010A and 2010B

On June 2, 2010 the University issued Series 2010A and 2010B revenue bonds through the CHHEFC. The Series 2010A revenue bonds were issued as fixed rate debt with an average coupon of 5% and the Series 2010B revenue bonds were issued as variable rate demand bonds (VRDBs), which are subject to optional and mandatory tender. The University is not required to obtain or maintain a liquidity facility for the bonds.

The Series 2010A bonds were issued with a \$5,637,000 original issue premium and an additional issue cost of \$806,000. The Series 2010B bonds were issued without an original issue premium or discount and an additional issue cost of \$158,000. The original issue premium and costs were capitalized by the University and are being amortized over the term of the bond issue. Interest payments on the 2010A bonds are payable semiannually and interest payments on the 2010B bonds are payable monthly. Principal payments for Series 2010A commence on May 15, 2031 and will be required annually until the scheduled maturity date of May 15, 2040. Principal payments for Series 2010B begin May 15, 2041 and continue annually until their maturity in May, 2048.

Unspent bond proceeds of \$100,038,000 at June 30, 2010 are invested in Bank of New York in an AAA rated U.S. government mutual fund.

The estimated fair value of the CHHEFC series 2010A bonds was \$100,280,000 at June 30, 2010. The estimated fair value of the CHHEFC Series 2010B bonds is equal to the face value at June 30, 2010.

Series 2008A and 2008B

On June 4, 2008 the University issued Series 2008A and 2008B revenue bonds through the CHHEFC. The Series 2008A and 2008B revenue bonds were issued as variable rate demand bonds (VRDBs), which are subject to optional and mandatory tender. The University is not required to obtain or maintain a liquidity facility for the bonds. The University has obtained a loan agreement from a group of banks that can only be used by the University to provide liquidity in the event the bonds are tendered but not successfully remarketed. This loan agreement expires on June 1, 2012 and calls for balances outstanding at maturity to be repaid over eight equal quarterly payments. The University has not experienced any difficulty in remarketing these bonds.

Original issuance costs of \$627,000 were capitalized by the University and are being amortized over the term of the bond issue. Principal payments commence on June 30, 2039 and are payable annually through June 30, 2048.

A portion of the proceeds of the Series 2008A and 2008B bonds was used to refund \$28,800,000 of commercial paper.

The estimated fair value for the Series 2008A and 2008B bonds approximates the face value at June 30, 2010.

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Series 2007A and 2007B

On June 12, 2007, the University issued Series 2007A and 2007B revenue bonds through the CHHEFC. The Series 2007A bonds were issued with a \$5,832,000 original issue premium and the Series 2007B bonds were issued net of a \$365,000 original issue discount. The original issue premium and discount and additional issuance costs of \$2,494,000 were capitalized by the University and are being amortized over the term of the bond issue. Interest payments on the bonds are payable semiannually. Principal payments for Series 2007A commenced on May 15, 2010 and will be required annually until the scheduled maturity date of May 15, 2047. Principal payments for Series 2007B begin November 15, 2030 and continue annually until their maturity in November 2037.

A portion of the proceeds of the Series 2007A and Series 2007B bonds was used to legally defease \$5,000,000 and \$42,400,000, respectively, of commercial paper. The obligation for this commercial paper was removed from the Statement of Financial Position as of June 30, 2007.

The estimated fair value of the CHHEFC Series 2007A bonds was \$216,649,000 at June 30, 2010 and \$216,339,000 at June 30, 2009. The estimated fair value of the CHHEFC Series 2007B bonds was \$103,056,000 at June 30, 2010 and \$96,584,000 at June 30, 2009.

Series 2006A and 2006B

In March 2006, the University issued Series 2006A and 2006B revenue refunding bonds in the amount of \$147,180,000. The Series 2006A and 2006B revenue refunding bonds were issued as VRDBs, which are subject to optional and mandatory tender. The University is required to maintain a liquidity facility for the bonds to provide liquidity in the event the bonds are tendered but not successfully remarketed. This liquidity facility expires on March 29, 2011 and calls for balances outstanding at maturity to be repaid over six equal semi-annual payments. The University has not experienced any difficulty in remarketing these bonds.

Proceeds from these bonds were used to advance refund the Series 1999A debt service obligation by irrevocably placing assets with a trustee to pay principal, interest and call premium on the obligations as they become due, and to current refund \$20,000,000 of the commercial paper program.

The estimated fair value of the CHHEFC Series 2006A and 2006B bonds approximates the face value at June 30, 2010 and 2009.

Effective March 29, 2006, the University entered into interest rate swap agreements with a notional amount of \$147,180,000. The University receives amounts based on 67% of the three-month London Interbank Offered Rate (LIBOR) and makes payments based on a fixed rate of 3.868%. The term of the swaps matches the term of the Series 2006A and 2006B bonds. The University has the option to terminate the swaps starting in 2016.

The fair value of the interest rate swap agreements is the estimated amount that the University would pay or receive to terminate these contracts as of June 30, 2010 and 2009. The estimated fair value of these swap arrangements was a liability of \$15,028,000 as of June 30, 2010 and a liability of \$9,533,000 as of June 30, 2009. The change in value is reported as other nonoperating expense for 2010 and 2009 in the Consolidated Statement of Activities.

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Excluding maturity of commercial paper and other notes payable, as well as unamortized discounts and premiums, principal payments are:

<i>(In thousands of dollars)</i>	<u>Scheduled Principal Payments</u>	<u>Outstanding VRDBs</u>	<u>Total Maximum Principal Payments</u>
2011	\$ 2,135	\$ 139,765	\$ 141,900
2012	2,220	124,060	126,280
2013	2,310	49,060	51,370
2014	2,405	49,060	51,465
2015	2,500	-	2,500
Thereafter	<u>778,970</u>	<u>(361,945)</u>	<u>415,025</u>
	<u>\$ 788,540</u>	<u>\$ -</u>	<u>\$ 788,540</u>

Outstanding VRDBs in the above table represent amounts payable in the event the bonds are tendered but are not successfully remarketed, as discussed previously.

Commercial Paper Notes

The University has a tax-exempt commercial paper credit facility that provides for borrowings in the form of individual notes up to an aggregate of \$100,000,000. The notes bear a fixed rate of interest, established on the borrowing date, over their individual terms, not to exceed 270 days. The outstanding balance under the facility was \$73,400,000 and \$65,000,000 with an average maturity of 80 days and 70 days as of June 30, 2010 and 2009, respectively. The average interest rate was 0.35% and 0.96% in 2010 and 2009, respectively.

The estimated fair value of the commercial paper notes approximates the face value.

Line of Credit

The University established a \$100,000,000 variable rate line of credit with a commercial bank in January, 2009. The line of credit expires on January 29, 2011. No funds were borrowed under this agreement during FY 2010.

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10. Net Assets

The University's unrestricted, temporarily restricted and permanently restricted net assets for the year ended June 30, 2010 are categorized by purpose as follows, with summarized information for the year ended June 30, 2009:

<i>(in thousands of dollars)</i>	2010			2009	
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total	Total
Internally designated for specific programs or ongoing activities	\$ 103,589	\$ -	\$ -	\$ 103,589	\$ 97,106
Designated or restricted by donor, including pledges	68,287	92,932	-	161,219	151,151
Net investment in plant	348,753	28,778	-	377,531	375,261
Endowment and designated for long-term investment including pledges	1,691,796	1,208,867	936,060	3,835,723	3,665,261
Life-income trusts	-	42,140	15,847	57,987	57,473
Loans	5,566	-	2,804	8,370	8,538
	<u>\$ 2,217,991</u>	<u>\$ 1,372,717</u>	<u>\$ 953,711</u>	<u>\$ 4,544,419</u>	<u>\$ 4,354,790</u>

The Board of Trustees has designated certain unrestricted and temporarily restricted net assets for long-term investment. Most net assets designated for long-term investment and endowment assets participate in one common investment pool (Note 5).

11. Student Financial Aid

Gross student tuition and fees of \$169,014,000 and \$153,824,000 in 2010 and 2009, respectively, are presented in the consolidated financial statements net of scholarship and fellowship awards of \$70,907,000 and \$62,631,000, respectively. Auxiliary enterprises revenue was reduced by scholarship awards applied to room and board charges of \$2,723,000 and \$1,787,000 in 2010 and 2009, respectively. Scholarship and fellowship awards in excess of the above amounts are reported as expense.

12. Functional Expenses

Educational and general expenses of the University by major functional category for the years ended June 30, 2010 and 2009, were as follows:

<i>(in thousands of dollars)</i>	2010	2009
Instruction and department research	\$ 225,494	\$ 214,120
Sponsored research and other sponsored programs	83,214	71,874
Library	30,904	29,036
Scholarships and fellowships	16,606	17,875
Student services	44,607	42,732
General administration	91,208	31,077
Institutional development and other activities	21,160	23,166
Total educational and general	<u>\$ 453,193</u>	<u>\$ 429,862</u>

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The above table includes depreciation expense of \$31,369,000 and \$24,109,000, and operations and maintenance expense of \$40,747,000 and \$41,866,000 in 2010 and 2009, respectively, which were allocated to the major functional categories based on space usage. Depreciation of library books of \$8,831,000 and \$8,452,000 was recognized as library expense in 2010 and 2009, respectively. In addition, depreciation expense of \$15,611,000 and \$12,016,000 was allocated to auxiliary enterprises in 2010 and 2009, respectively.

13. Related Party Transactions

Members of the University's Board of Trustees and senior management may, from time to time, be associated, either directly or through interlocking board memberships, with entities doing business with the University. The University employs a conflict of interest policy that requires any such associations to be disclosed in writing on an annual basis and updated as appropriate during the year. When such associations exist, measures are taken to mitigate any actual or perceived conflict, including recusal of the board member from any decisions involving the entity doing business with the University. The transactions with entities associated with trustees or senior management are not considered to be significant and may include investment management, common membership in investment partnerships or other investment vehicles, or the purchase of goods or services.

14. Retirement Plans

Substantially all employees are eligible to participate in a defined contribution retirement plan, which is administered by an outside agency. The plan operates in accordance with Section 401(a) of the Internal Revenue Code. University contributions are made to this plan. In addition, employees may elect to participate in plans created under Section 403(b) of the Internal Revenue Code. The contributions of the University and its employees may be applied to annuity contracts. The University's contributions to the plan of \$18,255,000 and \$17,459,000 were recorded as expense in the appropriate functional categories in 2010 and 2009, respectively.

15. Commitments and Contingencies

A number of suits and claims are pending against the University. While final outcomes cannot be determined at this time, management believes, after consultation with its legal counsel, that the uninsured liability, if any, resulting from these suits and claims will not have a material adverse effect on the University's financial position.

The University receives funding from federal government agencies for research and other programs conducted under government grants and contracts. The grants and contracts provide for reimbursement of direct and indirect costs. Indirect costs are reimbursed under a negotiated rate agreement with the federal government; the rate is predetermined through fiscal year 2011. The costs recovered by the University in support of federally sponsored programs are subject to audit and adjustment.

In connection with its private equity investment program (Note 4), the University is obligated under certain limited partnership agreements to advance additional funding up to levels specified in each agreement upon the request of the general partner. At June 30, 2010 and 2009, the University had unfunded commitments of \$622,737,000 and \$771,960,000, respectively, which are expected to be called primarily over the next five to seven years.

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Additionally, the University was committed under contracts at June 30, 2010 and 2009, for capital construction and improvements and major maintenance of approximately \$67,957,000 and \$90,710,000, respectively, to be financed primarily from gifts and net assets designated for long-term investments, and from debt to the extent other resources are not available. Other purchasing commitments of \$5,396,000 and \$5,432,000 were also outstanding at June 30, 2010 and 2009, respectively.