

Consolidated Financial Statements and Report of Independent Certified Public Accountants

**Houston Baptist University and Subsidiary**

May 31, 2011 and 2010

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## Report of Independent Certified Public Accountants

Board of Trustees  
Houston Baptist University

We have audited the accompanying consolidated statement of financial position of Houston Baptist University and its subsidiary (collectively, the "University") as of May 31, 2011, and the related statements of activities and cash flows for the year 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 audit. The financial statements of Houston Baptist University and its subsidiary as of May 31, 2010, were audited by other auditors whose report dated September 29, 2010, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America as established by the American Institute of Certified Public Accountants 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above presents fairly, in all material respects, the financial position of Houston Baptist University and its subsidiary as of May 31, 2011, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 14, 2011 on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information of the University's wholly owned subsidiary, Beechnut Street, Inc., and subsidiaries is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position and net income of the subsidiary. The consolidating information of Beechnut Street, Inc., and subsidiaries has been subjected to the auditing procedures applied in the audit of the consolidated financial statements of the University and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

*Fitts, Roberts & Co., P.C.*

Houston, Texas  
September 14, 2011

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**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**  
May 31, 2011 and 2010

	2011	2010
<b>Assets</b>		
Cash and cash equivalents	\$ 14,571,088	\$ 6,188,303
Receivables, principally from students, net of allowance for doubtful accounts of \$2,281,891 and \$1,950,598 in 2011 and 2010, respectively	3,897,761	4,521,329
Pledges receivable, net	1,461,287	2,498,028
Prepayments, inventories and other assets	1,418,625	1,428,814
Investments	75,631,372	65,654,188
Investment in plant assets, net	106,357,397	108,454,931
Interests in perpetual trusts held by others	3,873,119	3,228,070
Interests in trusts administered by others	69,833	100,077
Cash, restricted	920,000	-
TOTAL ASSETS	<u>\$ 208,200,482</u>	<u>\$ 192,073,740</u>
<b>Liabilities and Net Assets</b>		
Accounts payable and accrued liabilities	\$ 6,434,523	\$ 5,954,287
Deferred income	266,783	180,196
Deposits and agency funds	774,893	1,160,653
Interest rate swap	3,450,888	2,478,449
Notes payable	8,623,183	9,173,177
Bonds payable	51,160,000	52,100,000
TOTAL LIABILITIES	70,710,270	71,046,762
Net Assets:		
Unrestricted	72,621,060	61,008,200
Temporarily restricted	22,923,828	19,137,629
Permanently restricted	41,945,324	40,881,149
TOTAL NET ASSETS	<u>137,490,212</u>	<u>121,026,978</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$ 208,200,482</u>	<u>\$ 192,073,740</u>

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF ACTIVITIES**

Fiscal Years ended May 31, 2011 and 2010

	Unrestricted		Temporarily Restricted		Permanently Restricted		Total	
	2011	2010	2011	2010	2011	2010	2011	2010
Operating revenues and support								
Tuition and fees	\$ 52,360,202	\$ 48,707,794	\$ -	\$ -	\$ -	\$ -	\$ 52,360,202	\$ 48,707,794
Funded	(6,205,914)	(5,698,199)	-	-	-	-	(6,205,914)	(5,698,199)
Unfunded	(17,301,256)	(15,286,978)	-	-	-	-	(17,301,256)	(15,286,978)
Tuition and fees, net	28,853,032	27,722,617	-	-	-	-	28,853,032	27,722,617
Private gifts and grants:								
Baptist General Convention of Texas	419,990	444,593	-	-	-	-	419,990	444,593
Government grants & contracts	3,945,788	3,603,322	152,331	191,005	-	-	4,098,119	3,794,327
Gifts in kind	5,874	2,794,805	-	-	-	-	5,874	2,794,805
Other	855,353	986,420	3,000,126	2,478,934	-	-	3,855,479	3,465,354
Investment and endowment income	1,173,349	1,227,136	459,630	411,572	-	-	1,632,979	1,638,708
Sales and services of auxiliary enterprises	4,922,125	5,168,608	-	-	-	-	4,922,125	5,168,608
Net gain on operating asset	9,595,452	-	-	-	-	-	9,595,452	-
Other	225,577	184,073	-	-	-	-	225,577	184,073
BSI revenue	3,244,454	3,784,762	-	-	-	-	3,244,454	3,784,762
Net assets released from restriction:								
Satisfaction of program restrictions	3,161,979	3,623,122	(3,648,324)	(3,623,122)	486,345	-	-	-
Total operating revenues and support	56,402,973	49,539,458	(36,237)	(541,611)	486,345	-	56,853,081	48,997,847
Operating Expenses:								
Educational and general:								
Instructional	15,437,483	16,282,201	-	-	-	-	15,437,483	16,282,201
Academic support	3,802,992	3,830,938	-	-	-	-	3,802,992	3,830,938
Student services	4,031,230	4,345,016	-	-	-	-	4,031,230	4,345,016
Institutional support	11,213,111	10,863,087	-	-	-	-	11,213,111	10,863,087
Total education and general	34,484,816	35,321,242	-	-	-	-	34,484,816	35,321,242
Auxiliary enterprises	9,643,655	9,784,129	-	-	-	-	9,643,655	9,784,129
BSI expenses (excluding interest)	2,114,093	2,472,428	-	-	-	-	2,114,093	2,472,428
Total operating expenses	46,242,564	47,577,799	-	-	-	-	46,242,564	47,577,799

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF ACTIVITIES - CONTINUED**  
Fiscal Years ended May 31, 2011 and 2010

	Unrestricted		Temporarily Restricted		Permanently Restricted		Total	
	2011	2010	2011	2010	2011	2010	2011	2010
EXCESS (DEFICIT) OF OPERATING REVENUES OVER (UNDER) OPERATING EXPENSES	\$ 10,160,409	\$ 1,961,659	\$ (36,237)	\$ (541,611)	\$ 486,345	\$ -	\$ 10,610,517	\$ 1,420,048
Non-operating activities:								
Contributions	-	-	-	-	470,813	787,777	470,813	787,777
Net assets released from restrictions:								
Satisfaction of capital acquisition restrictions	4,292,964	4,101,905	(4,349,846)	(4,101,905)	56,882	-	-	-
Interest on indebtedness	(1,977,801)	(2,265,681)	-	-	-	-	(1,977,801)	(2,265,681)
Change in value of split interest agreements	-	-	564,671	118,877	50,135	3,794	614,806	122,671
Unrealized gain/(loss) on investments	(844,826)	(695,029)	6,813,246	3,083,787	-	-	5,968,420	2,388,758
Realized gain/(loss) on sale of investments	(17,886)	(22,406)	794,365	1,668,548	-	11,374	776,479	1,657,516
Casualty loss	-	(187,126)	-	-	-	-	-	(187,126)
Total from non-operating activities	1,452,451	931,663	3,822,436	769,307	577,830	802,945	5,852,717	2,503,915
Change in net assets	11,612,860	2,893,322	3,786,199	227,696	1,064,175	802,945	16,463,234	3,923,963
Net assets - beginning of year	61,008,200	58,114,878	19,137,629	18,909,933	40,881,149	40,078,204	121,026,978	117,103,015
Net assets - end of year	<u>\$ 72,621,060</u>	<u>\$ 61,008,200</u>	<u>\$ 22,923,828</u>	<u>\$ 19,137,629</u>	<u>\$ 41,945,324</u>	<u>\$ 40,881,149</u>	<u>\$ 137,490,212</u>	<u>\$ 121,026,978</u>

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
Fiscal Years ended May 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Cash flows from operating activities:		
Change in net assets	\$ 16,463,234	\$ 3,923,963
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Realized (gain) on sale of investments	(776,479)	(1,657,516)
Unrealized (gain) on investments	(6,940,859)	(2,891,023)
Loss from bond interest swap	972,439	502,264
Change in value of split-interest agreements and other trusts	(614,806)	(122,672)
Reinvested interest and dividends	(613,523)	(582,926)
Change in provision for doubtful accounts	775,173	768,783
Depreciation and amortization on investment in plant assets	4,213,271	4,237,676
Proceeds from contributions restricted for long-term investment	(470,813)	(787,776)
Changes in:		
Receivables, net	(151,605)	(1,393,170)
Pledges receivable, net	1,036,741	3,461,175
Prepayments, inventories, and other assets	10,189	(21,773)
Accounts payable and accrued liabilities	520,205	(841,141)
Deposits and agency funds	(385,760)	571,661
Deferred income	86,587	(304,096)
Net cash provided by operating activities	14,123,994	4,863,429
Cash flows from investing activities:		
Purchases of investments	(4,813,228)	(12,428,437)
Proceeds from sale of investments	3,166,906	12,205,557
Purchases of plant assets	(2,115,737)	(4,689,697)
Contractual payments on annuities	(39,969)	(545,749)
Net cash (used in) investing activities	(3,802,028)	(5,458,326)
Cash flows from financing activities:		
Proceeds from contributions restricted for long-term investment	470,813	787,776
Cash, restricted	(920,000)	-
Payments on bonds	(940,000)	(900,000)
Proceeds from capital leases	-	330,792
Payments on notes payable	(549,994)	(550,658)
Net cash (used in) financing activities	(1,939,181)	(332,090)
Net increase (decrease) in cash and cash equivalents	8,382,785	(926,987)
Cash and cash equivalents at beginning of year	6,188,303	7,115,290
Cash and cash equivalents at end of year	<u>\$ 14,571,088</u>	<u>\$ 6,188,303</u>
Noncash transactions		
Retirement of plant assets	\$ 20,711	\$ 886,004

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

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### **1. General**

Houston Baptist University (the "University") is a private, non-profit institution of higher education based in Houston, Texas. The University is affiliated with the Baptist General Convention of Texas and provides education and training services primarily for students at the undergraduate and graduate levels. The University is a non-profit organization exempt from Federal income taxes under 501(a) as an organization described in Section 501 (c)(3) of the Internal Revenue Code. The University is primarily supported by tuition and fees from students.

Beechnut Street, Inc. ("BSI") is a wholly-owned for-profit subsidiary of the University's Quasi Endowment Fund. BSI was established to hold and operate certain real estate and other investments. It owns a 21,953 square foot retail center and two adjoining ground leases situated on approximately 6.7 acres located on the northeast perimeter of the campus, known as Fondren II. In November 2007, BSI purchased Fondren I which consists of two in-line strip retail buildings containing 173,355 square feet, a freestanding retail store containing 9,000 square feet and one pad site improved with approximately 3,200 square feet of restaurant located on 15.2802 acres of land on the southeast corner of Fondren and US 59.

HB Housing Partnership I, LTD. (the "Partnership" or "HBHPI") is a Texas Limited Partnership that operates the student housing apartment complex known as Husky Village. The Partnership commenced operations in March 1997 with two limited partners, HB Housing Corp ("HBHC"), a Texas Corporation, and BSI. The Partnership entered into an amended ground lease dated February 2003, with Houston Baptist University and constructed a 143 unit apartment complex in three phases, designed and financed by the Partnership, that houses students attending Houston Baptist University. During the year ended August 2004, BSI purchased the ownership interest of HBHC and the Partnership, along with HBHC, became wholly-owned by BSI.

The consolidating balance sheet and consolidating statement of income of the Partnership, HBHC, and BSI prior to consolidation with the University are included in the supplemental schedules to this report.

##### **2. Basis of Presentation**

The consolidated financial statements include the accounts of the various academic and administrative divisions of the University, the Partnership and BSI. Inter-company balances and transactions are eliminated in consolidation.

Revenues, expenses, gains and losses are recorded on the accrual basis of accounting and are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the University are classified and reported as follows:

*Permanently restricted* - Net assets subject to donor-imposed stipulations that they be maintained permanently by the University. Generally, the donors of these assets permit the University to use all or part of the income earned on related investments for general or specific purposes. The income is included in temporarily restricted or unrestricted net assets as applicable.



## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Temporarily restricted - Net assets subject to donor-imposed stipulations that may or will be met either by actions of the University and/or the passage of time.

Unrestricted - Net assets that are not subject to donor-imposed stipulations.

Revenues from sources other than contributions are reported as increases in unrestricted net assets. Expenses are reported as decreases in unrestricted net assets. Gains or losses on investments are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulations or by law. Expirations of temporary restrictions recognized on net assets (e.g., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications from temporarily restricted net assets to unrestricted net assets. Temporary restrictions on gifts to acquire long-lived assets are considered met in the period in which the assets are acquired or placed in service.

Contributions, including unconditional promises to give, are recognized as revenues in the period received. Contributions of assets other than cash are recorded at their estimated fair value at the date of gift. Contributions to be received after one year are discounted at the three year treasury note rate. Amortization of the discount is recorded as additional contribution revenue in accordance with donor-imposed restrictions, if any, on the contributions. Allowance is made for uncollectible contributions based upon management's judgment and analysis of the creditworthiness of the donors, past collection experience and other relevant factors.

#### **3. Cash and Cash Equivalents**

Cash equivalents include time deposits, certificates of deposit, and highly liquid debt instruments with maturities of three months or less at date of acquisition.

#### **4. Accounts Receivable and Related Allowance for Doubtful Accounts**

Accounts receivable relate primarily to receivables from students. Tuition and registration charges relating to future semesters are recorded as deferred revenue when collected. Uncollected future fees are not recorded until the semester begins.

The estimated allowances for uncollectible accounts and notes receivable are accounted for using the reserve method. Under this method, allowances are maintained at a level which, in the judgment of management, is adequate to meet the present and potential risks of uncollectibility of the receivables. Management's judgment is based on a variety of factors, which include experience related to charge-offs and recoveries, and scrutiny of individual accounts. Amounts deemed by management to be uncollectible are charged to expense. Recoveries on receivables previously charged-off are credited to expense. Provisions for receivable losses are charged to expense and credited to the allowance for doubtful accounts.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

##### **5. Inventories**

Inventories, which consist primarily of textbooks, clothing, gifts and supplies are stated at cost and are expensed using the first in, first out method. Inventory is stated at the lower of cost or market.

##### **6. Investments**

Investments in corporate stocks and bonds are stated at quoted market value. Oil and gas royalty interests are valued by an independent appraiser. Other investments consist of a long term certificate of deposit which is carried at cost. Real estate is stated at fair market value as determined by independent appraisers. All real estate investments are held primarily for campus expansion and to function as sources of Quasi Endowment Fund income for the University. Real estate investment income is recognized net of related direct expenses. Investments in private investment funds are carried at net asset value as a practical expedient for determining fair values. The University may redeem its investments in private funds annually with 95 days notice.

Unrealized gains and losses resulting from increases and decreases in such fair market values are recognized during the period in which the change occurs.

Pooled endowment and similar funds are invested on the basis of a total return policy to provide income and to realize appreciation in investment values. Amounts distributed from endowment funds to support operations for general or specific purposes are based on the trailing twelve quarter average market value of the investment pool.

##### **7. Restricted Cash**

Under the Swap agreement between the University and Bank of America (Note H), the University is required to maintain a specified cash balance with the bank if the swap liability exceeds a certain threshold. As of the May 31, 2011 the required balance was \$920,000.

##### **8. Concentration of Credit Risk**

The University places its cash and cash equivalents with well capitalized financial institutions, which at times may exceed federally insured limits. The University has not experienced any losses of such accounts.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued**

##### **9. Investment in Plant Assets**

Investment in plant assets are stated at cost less accumulated depreciation and amortization. Cost is determined by the purchase price or fair value, if acquired by gift. Campus land, construction in progress, art and historical objects are not subject to depreciation or amortization. The University capitalizes items in excess of \$2,500 with a useful life of at least three years. Leasehold improvements are amortized over the shorter of the lease term or useful life of the asset. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets.

##### **10. Perpetual Trusts**

The University is the beneficiary of certain perpetual trusts held and administered by others, specifically the Baptist Foundation of Texas. The present values of the estimated future cash receipts from the trusts are recognized as assets and contribution revenues at the dates the trusts are established. Distributions of income from the trusts are recorded as contributions and the carrying value of the assets are adjusted for changes in the estimates of future receipts.

##### **11. Derivative Instruments and Hedging Activities**

The University follows FASB Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*, which establishes accounting and reporting standards for derivative instruments. Specifically, the standard requires all entities, including not-for-profit organizations, to recognize all derivatives as either assets or liabilities in their statement of financial position and to measure such instruments at fair value. Changes in the fair value of derivative financial instruments are recognized periodically as changes in net assets.

##### **12. Functional Expenses**

Costs related to the operation and maintenance of physical plant, including depreciation and amortization of plant assets, are allocated to program and supporting activities based upon the percentage of total assets utilized by the applicable program or activity (see Note G).

##### **13. Advertising Costs**

Advertising costs are expensed as incurred. Advertising costs were approximately \$681,000 and \$469,000 for 2011 and 2010, respectively, and were charged to operating expenses.

##### **14. Operating Revenues and Support and Non-operating Activities**

Revenues and expenses included in operating revenues and support relate primarily to the University's educational mission. Non-operating activities include contributions to endowments, interest on indebtedness, gains and losses on valuation and sales of assets, and a casualty loss as a result of damages sustained during Hurricane Ike which struck the Houston area on September 12, 2009.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

##### 15. 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 judgments that affect the reported amounts of assets and liabilities and disclosures of contingencies at the date of the financial statements and revenues and expenses recognized during the reporting period. Significant estimates made by management include estimated lives of depreciable assets, the estimated fair value of investments other than marketable securities (primarily real estate), the allowance for doubtful accounts, discounts on pledge receivables, the fair value of investments in perpetual trusts held by others, the estimated payable for life annuitants, and the fair value of the interest rate swap. Actual results could differ from those estimates.

##### 16. Fair Value Option

FASB ASC 825 *Financial Instruments* permits entities to choose to measure certain financial instruments and other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. As permitted by the standard, management elects not to elect the fair value option, for the financial assets and liabilities that had not been previously carried at fair value.

##### 17. Income Taxes

The University follows accounting guidance for how uncertain tax positions should be recognized, measured, presented, and disclosed in the financial statements. ASC 740 requires the evaluation of tax positions should be recognized, measured, presented, and disclosed in the financial statements. The standard requires the evaluation of tax positions taken or expected to be taken in the course of preparing tax returns to determine whether the tax positions are “more-likely-than-not” of being sustained by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. The University’s policy is to classify income tax related interest and penalties, in interest expense and other expense, respectively. The adoption of ASC 740 did not have an effect on the University’s net asset value, financial position or results of activities.

As of May 31, 2011 and 2010 and for the years then ended, the University and its subsidiary, BSI, did not have an asset or liability for any unrecognized tax positions. Management’s determinations regarding ASC 740 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an on-going analysis of tax laws, regulations and interpretations thereof. The University is subject to routine audits of the Internal revenue Service. The University believes it is no longer subject to audits for years prior to 2008.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

##### 18. Accounting Standards Codification

In June 2009, the Financial Accounting Standards Board (“FASB”) issued its final Statement of Financial Accounting Standards (“SFAS”) No. 168, “The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162” (“SFAS No. 168”). SFAS No. 168 established the FASB Accounting Standards Codification (“ASC”) as the single source of authoritative U.S. GAAP to be applied by nongovernmental entities in the preparation of financial statements. All guidance in the ASC carries an equal level of authority. The ASC supersedes all previously existing non-SEC accounting and reporting standards. The ASC simplifies user access to all authoritative U.S. GAAP by reorganizing previously issued U.S. GAAP pronouncements into approximately 90 accounting topics within a consistent structure, without creating new accounting and reporting guidance. The ASC became effective for financial statements issued for interim and annual periods ending after September 15, 2009; accordingly, the University adopted the ASC in the third quarter of fiscal 2009. Following SFAS No. 168, the FASB will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts; instead, it will issue Accounting Standards Updates. The FASB will not consider Accounting Standards Updates as authoritative in their own right; these updates will serve only to update the ASC, provide background information about the guidance, and provide the bases for conclusions on the change(s) in the ASC. For the discussion herein, the University refers to ASC citations that relate to ASC Topics and their descriptive titles, as appropriate, and no longer refer to citations that relate to accounting pronouncements superseded by the ASC.

#### NOTE B - ALLOWANCE FOR DOUBTFUL ACCOUNTS

An allowance for doubtful accounts is provided against student receivables as discussed in Note A. The allowance for doubtful accounts at May 31, consists of the following:

	<u>2011</u>	<u>2010</u>
Allowance for doubtful accounts - beginning of year	\$ 1,950,598	\$ 1,508,307
Add: provision for doubtful accounts	775,173	768,783
Less: accounts written off	<u>(442,880)</u>	<u>(326,492)</u>
Allowance for doubtful accounts - end of year	<u>\$ 2,282,891</u>	<u>\$ 1,950,598</u>

The provision for doubtful accounts is included in institutional support on the consolidated statements of activities.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE C - PLEDGES RECEIVABLE, NET

Pledges receivable, net, at May 31, consists of the following:

	<u>2011</u>	<u>2010</u>
Unconditional promise expected to be collected in:		
Less than one year	\$ 611,921	\$ 1,339,174
One year to five years	856,100	1,258,198
	<u>1,468,021</u>	<u>2,597,372</u>
Less unamortized discount	(6,734)	(20,752)
Less allowance for doubtful accounts	<u>-</u>	<u>(78,592)</u>
Total pledges receivable, net	<u>\$ 1,461,287</u>	<u>\$ 2,498,028</u>

Pledges receivable were discounted using rates ranging from .79% to 1.40%.

#### NOTE D - INVESTMENTS

Investments at fair value, at May 31, consist of the following:

	<u>2011</u>	<u>2010</u>
Common stocks	\$ 1,175,271	\$ 916,882
Bonds	7,356,078	5,184,064
Mutual funds	34,413,900	26,849,541
Private investment fund	5,052,074	4,674,286
Real estate	26,117,636	26,459,915
Oil and gas royalty interests	1,451,413	1,254,500
Certificate of deposit	<u>65,000</u>	<u>315,000</u>
Total	<u>\$ 75,631,372</u>	<u>\$ 65,654,188</u>

The University nets investment fees against investment and endowment income. Investment fees were approximately \$236,000 and \$254,000 for the years ended May 31, 2011 and 2010, respectively.

#### NOTE E - RISKS AND UNCERTAINTIES

The University invests in various investment securities. Investment securities are exposed to various risks, such as interest rate, overall market volatility and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the University's account balances and the amounts reported in the statements of financial position.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE F - SALE OF REAL ESTATE

In 2003 and 2005, the University sold the right to use certain real estate assets held for investment for approximately \$4,300,000 and \$1,112,000 respectively. Under the terms of these agreements, the land and improvements will revert back to the University in the year 2048 and 2020, respectively.

These transactions have been recorded as a sale of the property since the University will not have the right to the use of this land for approximately 44 and 14 years, respectively. Because the land and buildings will revert to the University, the current fair value of the property is being accrued into the financial statements over the 44 and 14 year periods prior to the reversion of the land and improvements. The amount accrued as an asset and income for the years ended May 31, 2011 and May 31, 2010 was approximately \$1,192,000 and \$1,020,000, respectively, and is reflected in investments on the consolidated financial statements of financial position.

#### NOTE G - INVESTMENT IN PLANT ASSETS, NET

Investment in plant assets, net, consists of the following at May 31:

	Estimated Useful Life	2011	2010
Buildings	20 - 50 years	\$ 100,559,799	\$ 100,974,008
Furniture, equipment, and library books	3 - 10 years	16,315,009	15,889,602
Land improvements	10 - 20 years	14,296,732	13,904,642
Software	10 years	2,154,409	2,154,409
Leasehold improvements	10 - 20 years	1,616,585	1,538,910
Vehicles	5 years	346,361	346,361
		135,288,895	134,807,932
Less accumulated depreciation and amortization		(37,947,506)	(34,148,445)
Campus land		2,135,654	2,135,654
Art and historical objects		5,602,855	5,602,855
Construction in progress		1,277,499	56,935
Total investment in plant assets		<u>\$ 106,357,397</u>	<u>\$ 108,454,931</u>

Depreciation and amortization expense for the years ended May 31, 2011 and 2010 was \$4,213,271 and \$4,237,676, respectively, and has been allocated to functional programs and supporting activities as follows:

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE G - INVESTMENT IN PLANT ASSETS, NET – Continued

Operation of plant expense for the years ended May 31, 2011 and 2010 was \$4,653,621 and \$5,012,000, respectively, and has been allocated to functional programs and supporting activities as follows:

	Depreciation and Amortization Expense		Operation of Plant Expense	
	2011	2010	2011	2010
Instructional	\$ 1,234,504	\$ 1,243,018	\$ 1,218,413	\$ 1,290,636
Academic support	381,926	384,559	376,948	399,292
Student services	274,053	275,942	270,481	286,514
Institutional support	632,914	637,279	624,665	661,692
Auxiliary enterprises	1,372,071	1,381,538	1,354,192	1,434,463
BSI	317,798	315,340	808,922	939,403
	<u>\$ 4,213,266</u>	<u>\$ 4,237,676</u>	<u>\$ 4,653,621</u>	<u>\$ 5,012,000</u>

#### NOTE H - DEBT

	May 31, 2011	May 31, 2010
<b><u>Bonds</u></b>		
Crawford Education Facilities Corporation (“CEFC”) bonds (Bank of New York as Trustee), issued November 2007 in the amount of \$53,000,000 due in annual installments ranging from \$900,000 to \$3,220,000, beginning December 1, 2009 thru December 1, 2037. The interest rate is Securities Industry and Financial Markets Association (“SIFMA”) plus 0.825%. On November 1, 2010, the bonds were remarketed publicly backed by a letter of credit from Bank of America. Under this agreement, the interest rate is SIFMA. At May 31, 2011, the interest rate was .18%. The bonds are secured by 6.686 acres of land, including improvements, and the future revenues of the University.	\$51,160,000	\$52,100,000

#### **Notes Payable**

A note payable with a bank dated November 20, 2004 of \$6,995,670, requiring 83 monthly principal and interest payments of \$41,188 with the balance due at the maturity on November 20, 2011. The note bears interest at 5% and is secured by a ground lease on 7.6660 acres and all tenant rents and leases.	5,919,942	6,108,808
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# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE H - DEBT – Continued

A note payable with a bank dated November 1, 2000 of \$2,500,000, requiring monthly payments of principal and interest of \$24,795 plus the balance at maturity, bearing interest at LIBOR plus 1.2%. The note was refinanced August 10, 2007 in the amount of \$3,000,000 requiring 60 monthly payments of principal and interest of \$26,965, commencing August 28, 2007, which assumes an effective interest rate of 7% over a 15 year amortization period. The note bears interest at LIBOR plus 1.2%, matures August 12, 2012 and is secured by the 1<sup>st</sup> lien on Fondren II and the ground leases from the tenants. The note is guaranteed by the University.

2,052,627 2,342,850

A note payable with a bank dated February 9, 2005 of \$500,000 requiring 84 monthly payments of principal and interest of \$2,948 with the balance due at the maturity on February 20, 2012. The note bears interest at 5% and is secured by a ground lease on 7.6660 acres and all tenant rents and leases.

425,470 438,902

### Capital Leases

A capital lease arrangement with a leasing company dated August 14, 2009 of \$201,000, requiring 60 monthly payments of principal and interest of \$4,475 ending September 31, 2014.

139,845 173,734

A capital lease arrangement with a bank dated July 27, 2009 of \$129,792, requiring 60 monthly payments of principal and interest of \$2,599 ending July 31, 2014.

85,299 108,883

Total notes payable and capital leases

8,623,183 9,173,177

Total debt

\$ 59,783,183 \$ 61,273,177

Future minimum payments under this debt are as follows:

May 31,	Bonds	Notes payable	Capital leases	Total
2012	\$ 980,000	\$ 6,596,066	\$ 84,888	\$ 7,660,954
2013	1,035,000	1,801,973	84,888	2,921,861
2014	1,080,000	-	84,888	1,164,888
2015	1,130,000	-	23,098	1,153,098
2016	1,180,000	-	-	1,180,000
Thereafter	45,755,000	-	-	45,755,000
Subtotal	51,160,000	8,398,039	277,762	59,835,801
Less amounts representing interest	-	-	(52,618)	(52,618)
Total	\$ 51,160,000	\$ 8,398,039	\$ 225,144	\$ 59,783,183

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE H - DEBT – Continued**

The interest expense on notes and bonds payable for the years ending May 31, 2011 and 2010, respectively, was approximately \$1,978,000 and \$2,266,000. The interest paid on notes and bonds payable for the years ending May 31, 2011 and 2010, respectively, was approximately \$2,019,000 and \$2,274,000.

The Master Bond Agreement contains a swap provision. Effective February 1, 2008, the University executed two interest rate swaps in the amounts of \$26,000,000 and \$12,000,000. The swaps bear interest at 3.8275% and 3.395% and mature December 1, 2037 and February 1, 2018, respectively. The University entered into the agreement to lock in fixed interest rates on the variable rate debt and is not using the agreements for speculative purposes. The amount recorded in net assets for the changes in value of the instrument was an unrealized loss of approximately \$972,000 and \$502,000, at May 31, 2011 and 2010, respectively, and is included in unrealized gain (loss) on sale of investments in the consolidated statements of activities.

The terms of the Master Bond Agreement require the University to maintain certain ratios in accordance with the agreements. At May 31, 2009, the University was not in compliance with these ratios; however, the University and the bondholder executed a waiver agreement through August 31, 2009 for all instances of default. In April 2010, the bond documents were amended and the debt covenants were modified. At May 31, 2010, the University was in compliance with these revised covenants. On November 1, 2010, the bonds were remarketed publicly backed by a letter of credit from Bank of America. Under this new agreement, the debt covenants were again modified. As of May 31, 2011, the University was in compliance with the covenants in effect under the remarketing agreement.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts and estimated fair values of the University's financial instruments are as follows:

	2011		2010	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:				
Cash and cash equivalents	\$ 14,571,088	\$ 14,571,088	\$ 6,188,303	\$ 6,188,303
Receivables - principally from students, net	3,897,761	3,897,761	4,521,329	4,521,329
Pledges receivable, net	1,461,287	1,461,287	2,498,028	2,498,028
Investments:				
Common stocks	1,175,271	1,175,271	916,882	916,882
Bonds	7,356,078	7,356,078	5,184,064	5,184,064
Mutual funds	34,413,900	34,413,900	26,849,541	26,849,541
Private investment fund	5,052,074	5,052,074	4,674,286	4,674,286
Real estate	26,117,636	26,117,636	26,459,915	26,459,915
Oil and gas royalty interests	1,451,413	1,451,413	1,254,500	1,254,500
Certificate of deposit	65,000	65,000	315,000	315,000
Interests in perpetual trusts held by others	3,873,119	3,873,119	3,228,070	3,228,070
Interest in trusts administered by others	69,833	69,833	100,077	100,077
Financial liabilities:				
Accounts payable and accrued liabilities	6,434,523	6,434,523	5,954,287	5,954,287
Deposits and agency funds	774,893	774,893	1,160,653	1,160,653
Interest rate swap	3,450,888	3,450,888	2,478,449	2,478,449
Bonds payable	51,160,000	51,160,000	52,100,000	52,100,000
Notes payable	8,398,039	8,351,751	8,890,559	8,884,433
Capital leases payable	225,144	225,144	282,617	282,617

The methods and assumptions used to estimate the fair value of each class of financial instruments are as follows:

#### Cash and cash equivalents

The carrying amount approximates fair value due to the short maturity of those instruments.

#### Receivables- principally from students - net

The carrying amount approximates fair value based on the short maturities of accounts receivable.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued**

##### Pledges receivable - net

The fair value of pledges receivable is based on the discounted value of expected future cash flows.

##### Investments

Corporate stocks and bonds and real estate are carried at market value; therefore, the carrying value approximates fair value. Other investments consist of a long-term certificate of deposit carried at amortized cost which approximates fair value.

##### Interests in perpetual trusts held by others

The interests in trusts held by others are carried at fair value which is determined using the net asset value of shares held by the trusts.

##### Interests in trusts administered by others

The interests in trusts administered by others are carried at fair value which is determined using the net asset value of shares held by the trusts.

##### Accounts payable, accrued liabilities, deposits and agency funds

The carrying amount approximates fair value because of the short maturity of the financial instruments.

##### Bonds payable

The carrying value approximates fair value based on the variable interest rates of the bonds payable.

##### Interest rate swap

The interest rate swap is carried at fair value as determined by using current market rates.

##### Notes payable

The estimated fair value of notes payable is based on discounting future cash flows using current interest rates at which similar loans could be obtained for the same remaining maturities.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

The University follows the fair value guidance for its financial assets and liabilities. The guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability, in an orderly transaction between market participants at the measurement date. The guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The three levels of inputs that may be used to measure fair value:

- Level 1: Inputs based on quoted market prices for identical assets or liabilities in active markets at the measurement date.
- Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. The inputs are unobservable in the market and significant to the instruments valuation.

The following table classifies the University's financial assets and liabilities measured at fair value on a recurring basis as of May 31, 2011:

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

Description	May 31, 2011	Level 1	Level 2	Level 3
<b>Financial assets:</b>				
Investments:				
Common stocks by sector:				
Basic material	\$ 204,241	\$ 204,241	\$ -	\$ -
Financial	336,036	336,036	-	-
Services	336,566	336,566	-	-
Other	298,428	298,428	-	-
Bonds:				
US Government	5,253,789	5,253,789	-	-
US Corporate	2,102,289	-	2,102,289	-
Mutual funds:				
Stocks	32,496,831	19,619,700	12,877,131	-
Bonds	1,917,069	-	1,917,069	-
Certificate of deposit	65,000	65,000	-	-
Private investment fund	5,052,074	-	5,052,074	-
Real estate	26,117,636	-	-	26,117,636
Oil and gas royalty interest	1,451,413	-	-	1,451,413
Interest in perpetual trusts held by others	3,873,119	-	3,873,119	-
Interests in trusts administered by others	69,833	-	69,833	-
Total investments at fair value	<u>\$ 79,574,324</u>	<u>\$ 26,113,760</u>	<u>\$25,891,515</u>	<u>\$ 27,569,049</u>
<b>Financial liabilities:</b>				
Interest rate swap	<u>\$ 3,450,888</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,450,888</u>

The University has made capital commitments to the investment manager of the alternative investment of \$4,584,000. As of May 31, 2011, all of this capital commitment has been funded.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

The following table classifies the University's financial assets and liabilities measured at fair value on a recurring basis as of May 31, 2010:

Description	May 31, 2010	Level 1	Level 2	Level 3
<b>Financial assets:</b>				
Investments:				
Common stocks by sector:				
Basic material	\$ 152,286	\$ 152,286	\$ -	\$ -
Financial	323,272	323,272	-	-
Services	220,150	220,150	-	-
Other	221,174	221,174	-	-
Bonds:				
US Government	5,040,324	5,040,324	-	-
US Corporate	143,740	22,377	121,363	-
Mutual funds:				
Stocks	25,124,100	15,196,229	9,927,871	-
Bonds	1,725,441	-	1,725,441	-
Certificate of deposit	315,000	315,000	-	-
Private investment fund	4,674,286	-	4,674,286	-
Real estate	26,459,915	-	-	26,459,915
Oil and gas royalty interest	1,254,500	-	-	1,254,500
Interest in perpetual trusts held by others	3,228,070	-	3,228,070	-
Interests in trusts administered by others	100,077	-	100,077	-
Total investments at fair value	<u>\$ 68,982,335</u>	<u>\$ 21,490,812</u>	<u>\$19,777,108</u>	<u>\$ 27,714,415</u>
<b>Financial liabilities:</b>				
Interest rate swap	<u>\$ 2,478,449</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,478,449</u>

The schedule below summarizes the activity for the year ended May 31, 2011 for the items on the previous table which have been classified as Level 3:

	Real estate	Oil and gas Royalty interests	Interest rate swap
Balance, beginning of year	\$ 26,459,915	\$ 1,254,500	\$ (2,478,449)
Total gains (losses)			
Included in realized/unrealized	(342,279)	196,913	(972,439)
Balance, end of year	<u>\$ 26,117,636</u>	<u>\$ 1,451,413</u>	<u>\$ (3,450,888)</u>

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

The schedule below summarizes the activity for the year ended May 31, 2010 for the items on the previous table which have been classified as Level 3:

	Real estate	Oil and gas Royalty interests	Interest rate swap
Balance, beginning of year	\$ 26,437,193	\$ 1,234,813	\$ (1,976,185)
Total gains (losses)			
Included in realized/unrealized	22,722	19,687	(502,264)
Balance, end of year	<u>\$ 26,459,915</u>	<u>\$ 1,254,500</u>	<u>\$ (2,478,449)</u>

Total Level 3 gains or losses above are all included in the consolidated statements of activities, and all relate to financial assets and liabilities still held at year end.

#### NOTE J - RETIREMENT PLAN AND TUITION REIMBURSEMENT

In 1963, the University established a retirement plan for all regular full-time faculty members and administrative staff. In compliance with the Tax Reform Act of 1986, the plan (a defined contribution plan) was amended in January 1989. Employees who complete one year of service and who work a total of 1,000 hours during a calendar year are eligible to participate. Upon an employee reaching eligibility, contributions are made to the plan by the University in an amount equal to 5% of the participant's salary. In addition, the University will contribute an amount equal to the participant's contribution, not to exceed 2.5% of the participant's salary. Effective June 1, 2009, the University contribution has been temporarily discontinued.

Employees may make voluntary contributions up to the limit allowed by law. Effective January 1, 1992, retirement benefits for new employees vest 100% after five years of employment. Participants in the plan prior to January 1, 1992 are fully vested from the time of initial contribution. Participants can elect to retire at various ages under the plan with the earliest being at age 55. Contributions to the Plan by the University were approximately \$821,000 and \$875,000 for 2011 and 2010, respectively.

Effective January 1, 2007 in an effort to encourage long-term continuous service, faculty and staff members who have completed ten continuous years of fulltime employment at the University are eligible for tuition benefits for their children to attend other universities. An eligible faculty or staff member may receive up to 80% of the tuition remission amount that would have been received had the child attended the University. For the years ended May 31, 2011 and 2010 approximately \$44,000 and \$78,000 were expensed, respectively. After the fall term of 2009, this long-term tuition benefit was discontinued, though some grandfathered benefits are still being paid.

Also, faculty or staff members who have completed six months of continuous fulltime employment at the University prior to the first day of the academic semester are eligible for tuition benefits for themselves as well as eligible spouses and children. For the years ended May 31, 2011 and 2010, approximately \$498,000 and \$764,000 were expensed, respectively.



## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE K - TRUST FUNDS HELD BY OTHERS

The University is the beneficiary of several trust funds administered primarily by the Baptist Foundation of Texas. No provision has been made for releasing trust principal to the University, except for the payment of specific capital improvements authorized under specified conditions of each trust. The amount of original trust principal has a fair value of approximately \$3,943,000 and \$3,328,000 on May 31, 2011 and 2010, respectively. Income distributions from these funds were approximately \$207,000 and \$201,000 in 2011 and 2010, respectively.

The University is the beneficiary of trust funds from various estates. Substantially all distributions from such trust funds are royalty income and totaled approximately \$254,000 and \$250,000 in 2011 and 2010, respectively, and are recorded in investment and endowment income.

#### NOTE L – NET ASSETS

Temporarily restricted net assets consist of the following at May 31:

	2011	2010
Pledges receivable principally for student, facilities and campus enhancements	\$ 1,293,464	\$ 2,032,437
Net cumulative income from endowment funds – (including unrealized gains) primarily for scholarships	16,545,974	10,492,260
Funds administered by others – life annuity funds	69,833	100,077
Trusts held by others	1,871,402	1,367,965
Student scholarships and loans	546,171	542,456
Equipment, renovations and operations	2,662,868	4,423,387
Life annuity funds	(65,884)	179,047
Total	<u>\$ 22,923,828</u>	<u>\$ 19,137,629</u>

Permanently restricted net assets and the purpose for which the income from those net assets is expendable are as follows:

	2011	2010
General endowment funds	\$ 33,849,711	\$ 32,836,477
Endowed academic scholarship funds	7,685,766	7,595,981
Life annuity funds	182,501	221,345
Student loan funds	227,346	227,346
Total	<u>\$ 41,945,324</u>	<u>\$ 40,881,149</u>

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE M - DEVELOPMENT EXPENSES

The University incurred expenses totaling approximately \$784,000 and \$1,099,000 for the years ended May 31, 2011 and 2010, respectively, related to development and fund-raising. Such amounts are included in institutional support expenses in the accompanying consolidated statements of activities.

#### NOTE N - COMMITMENTS AND CONTINGENCIES

The University is the lessor of operating leases with third parties expiring in various years through 2022. Minimum future rental income under non-cancelable operating leases having remaining terms in excess of one year as of May 31 are:

	University	BSI	Total
2012	\$ 697,123	\$ 1,371,414	\$ 2,068,537
2013	655,211	837,625	1,492,836
2014	554,606	689,760	1,244,366
2014	346,042	563,462	909,504
2016	123,101	347,549	470,650
Thereafter	597,662	599,485	1,197,147
Total minimum future rental income	<u>\$ 2,973,745</u>	<u>\$ 4,409,295</u>	<u>\$ 7,383,040</u>

Rental income for the years ended May 31, 2011 and 2010 was approximately \$2,520,000 and \$2,751,000, respectively, and has been included in the investment and endowment income on the consolidated statements of activities.

The University participates in various federal loan programs. In March 2010, Congress passed the Health Care and Education Reconciliation Act of 2010. Under this act, the federal government stopped giving subsidies to private banks to give out federally insured loans. Instead, loans will be administered directly by the Department of Education. Subsequent to the passing of this Act, the Federal Direct Loan Program is the sole government-backed loan program in the United States, replacing the Federal Family Education Loan Program. The amount of loans disbursed under the Federal Family Education Loan Program for the years ended May 31, 2011 and 2010 was approximately \$31,000 and \$15,269,000, respectively. The amount of loans disbursed under the Direct Loan Program for the year ended May 31, 2011 was approximately \$15,687,000. Amounts questioned as a result of audits, if any, may result in the University purchasing the loan(s) from the lender as the loan(s) may have lost its (their) guaranteed status. Management believes that such amounts, if any, would be immaterial to the financial statements.

Activity of the Pell Grant program is not reflected in the consolidated statements of activities as the transactions are considered to be agency transactions. Students received approximately \$4,271,000 and \$4,046,000 from the Federal Pell Grant programs during fiscal years 2011 and 2010, respectively.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE N - COMMITMENTS AND CONTINGENCIES - Continued**

The University participates in various federal Title IV financial aid programs. The Department of Education requires private nonprofit institutions to demonstrate financial responsibility by meeting certain ratio requirements. The University was in compliance with these requirements at May 31, 2011 and May 31, 2010.

#### **NOTE O - ENDOWMENTS**

The University's endowment consists of approximately 365 individual funds established for a variety of purposes. Its endowment includes both donor-restricted endowment funds and funds designated by the Board of Trustees to function as endowments. As required by generally accepted accounting principles ("GAAP"), 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 Board of Trustees of the University has interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value 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 donated 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 in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization 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 donor-restricted 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 policy of the University.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE O - ENDOWMENTS - Continued**

**2011**

**Endowment Net Asset Composition by Type of Fund as of May 31, 2011**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$18,421,325	\$41,945,324	\$60,366,649
Board-designated endowment Funds	23,300,784	-	-	23,300,784
<b>Total Funds</b>	<b>\$23,300,784</b>	<b>\$18,421,325</b>	<b>\$41,945,324</b>	<b>\$83,667,433</b>

**Changes in Endowment Net Assets for the Fiscal Year Ended May 31, 2011**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$23,750,160	\$12,139,350	\$40,881,149	\$76,770,659
Investment return:				
Investment income	252,385	391,384	-	643,769
Net (depreciation) appreciation (realized and unrealized)	(147,004)	8,172,282	50,136	8,075,414
Total investment return	105,381	8,563,666	50,136	8,719,183
Rental income	685,840	-	-	685,840
BSI revenue	3,244,454	-	-	3,244,454
Contributions	-	6,000	470,813	476,813
Appropriation of endowment assets for expenditure	(1,999,088)	(2,285,365)	85,285	(4,199,168)
Other changes:				
BSI expenses	(2,114,093)	-	-	(2,114,093)
Interest expense	(359,981)	-	-	(359,981)
Miscellaneous income/(expense)	(11,889)	(2,326)	-	(14,215)
BSI payable to Quasi Endowment	-	-	-	-
Intercompany adjustment	-	-	457,941	457,941
<b>Endowment net assets, end of year</b>	<b>\$23,300,784</b>	<b>\$18,421,325</b>	<b>\$41,945,324</b>	<b>\$83,667,433</b>

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE O - ENDOWMENTS - Continued**

**2010**

**Endowment Net Asset Composition by Type of Fund as of May 31, 2010**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$12,139,350	\$40,881,149	\$53,020,499
Board-designated endowment Funds	23,750,160	-	-	23,750,160
<b>Total Funds</b>	<b><u>\$23,750,160</u></b>	<b><u>\$12,139,350</u></b>	<b><u>\$40,881,149</u></b>	<b><u>\$76,770,659</u></b>

**Changes in Endowment Net Assets for the Fiscal Year Ended May 31, 2010**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$23,471,911	\$8,613,854	\$40,078,204	\$72,163,969
Investment return:				
Investment income	267,547	345,691	-	613,238
Net appreciation (realized and unrealized)	(225,130)	4,871,213	11,374	4,657,457
Total investment return	42,417	5,216,904	11,374	5,270,695
Rental income	756,103	-	-	756,103
BSI revenue	3,784,762	-	-	3,784,762
Contributions	-	-	791,571	791,571
Appropriation of endowment assets for expenditure	(2,040,000)	(2,682,685)	-	(4,722,685)
Other changes:				
BSI expenses	(2,472,428)	-	-	(2,472,428)
Interest expense	(374,089)	-	-	(374,089)
Miscellaneous income/(expense)	(284,397)	812,214	-	527,817
BSI payable to Quasi Endowment	1,573,971	-	-	1,573,971
Intercompany adjustment	(708,090)	179,063	-	(529,027)
<b>Endowment net assets, end of year</b>	<b><u>\$23,750,160</u></b>	<b><u>\$12,139,350</u></b>	<b><u>\$40,881,149</u></b>	<b><u>\$76,770,659</u></b>

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE O - ENDOWMENTS - Continued

##### Description of Amounts Classified as Permanently Restricted Net Assets and Temporarily Restricted Net Assets (Endowment Only)

	<u>May 31, 2011</u>	<u>May 31, 2010</u>
<b>Temporarily Restricted Net Assets</b>		
The portion of perpetual endowment funds subject to a time restriction under UPMIFA:		
Without purpose restrictions	\$ 3,007,836	\$ 1,727,150
With purpose restrictions	15,413,489	10,412,200
<b>Total endowment funds classified as temporarily restricted net assets</b>	<u><u>\$18,421,325</u></u>	<u><u>\$12,139,350</u></u>
<b>Permanently Restricted Net Assets</b>		
The portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or by UPMIFA	\$41,945,324	\$40,881,149
<b>Total endowment funds classified as permanently restricted net assets</b>	<u><u>\$41,945,324</u></u>	<u><u>\$40,881,149</u></u>

#### 1. Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires the University to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature are \$152,435 and \$421,634 as of May 31, 2011 and May 31, 2010, respectively and are included in satisfaction of program restrictions on the Consolidated Statement of Activities. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new permanently restricted contributions and continued appropriation for certain programs was deemed prudent by the Board of Trustees of the University.

#### 2. Return Objectives and Risk Parameters

The University has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the real purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the University must hold in perpetuity or for a donor-specified period(s) as well as board-designated funds. Under this policy, as approved by the Board of Trustees, the endowment assets are invested in a manner that is intended to produce results that earn an average rate of return at least equal to the nominal spending rate policy plus the rate of inflation plus an additional return of 1%, net of all fees, including management advisory fees and custody charges, over the long term (defined as rolling 5 year periods).

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE O - ENDOWMENTS - Continued

##### 3. Strategies Employed for Achieving Objectives

To achieve its investment objective, the Fund's assets are considered to be divided into two major components: Drivers of Return and Risk Reducing assets. The Investment Committee will determine the classification of alternative or market neutral investments. The Fund's long-term commitment to these classes shall be:

	<u>Range</u>	<u>Long-term Target</u>
Drivers of return	55%-75%	65%
Risk reducing assets	25%-45%	35%

##### 4. Spending Policy and How the Investment Objectives Relate to Spending Policy

The University has a policy of appropriating for distribution each year 5 percent of its endowment fund's average fair value over the prior 12 quarters through the fiscal year ended preceding the fiscal year in which the distribution is planned. In establishing this policy, the University considered the long-term expected return on its endowment. Accordingly, over the long-term, the University expects the current spending policy to allow its endowment to grow. This is consistent with the University's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return.

#### NOTE P - RELATED PARTY TRANSACTIONS

During the year, the University made payments to various vendors who meet the requirements of a related party. The nature of these transactions is described below:

- A consultant firm was engaged to provide enrollment management strategy services to the University during the year ended May 31, 2007. The Chairman of the Board of the holding company which owns the firm, and who is also a principle owner of the firm, serves on the Board of Trustees of the University and is the Chairman of the Finance Committee. The board member became an owner in this firm subsequent to the contract between the University and the firm. In addition, the University's Vice President of Enrollment Services is a paid consultant for the firm. Total fees paid to this company were \$67,000 and \$66,000 for the years ended May 31, 2011 and 2010, respectively.
- A firm that provides property management services was engaged by the University's for-profit subsidiary, Beechnut Street, Inc. to manage its retail space in July 2010. The firm's Senior Vice President is the brother of the University's Vice President for Financial Operations. Total fees paid to this firm by the University were \$44,000 for the year ended May 31, 2011.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE P - RELATED PARTY TRANSACTIONS - Continued

BSI holds the ground lease for three properties that are owned by the University. They are the Fondren I Shopping Center, the Fondren II Shopping Center and the Husky Village Apartments. The amount of rental income for Fondren I paid by BSI to the University for the years ended May 31, 2011 and 2010, respectively, was approximately \$816,000 and \$810,000, which eliminates in consolidation. The amount of rental income for Fondren II paid by BSI to the University for the years ended May 31, 2011 and 2010, respectively, was approximately \$117,000 and \$118,000, which eliminates in consolidation. The amount of rental income for Husky Village paid by BSI to the University for the years ended May 31, 2011 and 2010, respectively, was approximately \$70,000 and \$92,000, which eliminates in consolidation.

#### NOTE Q – SACS CORE REQUIREMENT 2.11.1

The University is a member of the Southern Association of Colleges and Schools (“SACS”). As part of the reaffirmation process with SACS, the University must comply with core requirements, as outlined in *The Principles of Accreditation: Foundations for Quality Enhancement*. Core requirement 2.11.1 requires a separate financial schedule calculating unrestricted net assets, exclusive of plant assets and plant related debt, as follows:

	May 31, 2011	May 31, 2010
Unrestricted net assets	\$ 72,621,060	\$ 61,008,200
Less: Investment in campus plant	(98,276,723)	(100,071,928)
Add: Interest rate swap derivative related to campus plant debt	3,450,888	2,478,449
Add: Debt related to campus plant	51,385,144	52,382,613
Unrestricted net assets, exclusive of plant and plant related debt	<u>\$ 29,180,369</u>	<u>\$ 15,797,334</u>

#### NOTE R – LITIGATION AND INSURANCE SETTLEMENT

The University and its subsidiary are subject to legal actions arising in the ordinary course of business. Management does not believe that the outcome of any legal actions would have a material adverse affect on the consolidated financial position or changes in its net assets.

In February 2011, the University was awarded a confidential settlement for damages sustained during Hurricane Ike. The settlement proceeds, net of certain related expenses, is presented in the consolidated statement of activities as a net gain on operating asset.

#### NOTE S – SUBSEQUENT EVENTS

The University has evaluated all events that occurred between May 31, 2011 and September 14, 2011, the date the consolidated financial statements were available to be issued. The University is not aware of any subsequent events which would require recognition or disclosure in the consolidated financial statements.



**Houston Baptist University and Subsidiary**

SUPPLEMENTAL SCHEDULES  
CONSOLIDATING BALANCE SHEET  
BEECHNUT STREET, INC. AND SUBSIDIARIES  
May 31, 2011

	<b>Beechnut Street, Inc.</b>						
	<b>BSI</b>	<b>Fondren I</b>	<b>Fondren II</b>	<b>HBHC</b>	<b>HBHP I</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Assets</b>							
Cash and cash equivalents	\$ 41,312	\$ 46,520	\$ 10,517	\$ -	\$ 754,925	\$ -	\$ 853,274
Accounts receivables	-	21,030	-	-	-	-	21,030
Prepays and other assets	-	8,580	-	-	-	-	8,580
Investment in subsidiary	707,827	-	-	-	-	(707,827)	-
Investments in real estate	1,447,636	-	-	-	-	-	1,447,636
Plant, property, and equipment, net accumulated depreciation of \$3,245,510 in 2011.	23,327	1,051,577	723,654	-	5,976,398	-	7,774,956
Receivable from University	-	-	-	-	-	-	-
Intercompany Receivable	-	6,898	2,514,558	-	12,854	(2,534,310)	-
<b>TOTAL ASSETS</b>	<b>\$ 2,220,102</b>	<b>\$ 1,134,605</b>	<b>\$ 3,248,729</b>	<b>\$ -</b>	<b>\$ 6,744,177</b>	<b>\$ (3,242,137)</b>	<b>\$ 10,105,476</b>
<b>Liabilities and Net Assets</b>							
Accounts payable and accrued expenses	\$ 11,679	\$ 88,018	\$ 31,417	\$ -	\$ 131,638	\$ -	\$ 262,752
Payable to University	1,128,645	864,315	176,610	979	8,329	-	2,178,878
Deferred revenues	-	7,140	16,675	-	-	-	23,815
Notes payable	-	425,470	2,052,627	-	5,919,942	-	8,398,039
Intercompany payable	2,534,310	-	-	-	-	(2,534,310)	-
<b>Total liabilities</b>	<b>3,674,634</b>	<b>1,384,943</b>	<b>2,277,329</b>	<b>979</b>	<b>6,059,909</b>	<b>(2,534,310)</b>	<b>10,863,484</b>
Shareholders' equity (deficit)	(1,454,532)	(250,338)	971,400	(979)	684,268	(707,827)	(758,008)
<b>Total liabilities and shareholders' equity (deficit)</b>	<b>\$ 2,220,102</b>	<b>\$ 1,134,605</b>	<b>\$ 3,248,729</b>	<b>\$ -</b>	<b>\$ 6,744,177</b>	<b>\$ (3,242,137)</b>	<b>\$ 10,105,476</b>

See Report of Independent Certified Public Accountants

**Houston Baptist University and Subsidiary**

SUPPLEMENTAL SCHEDULES  
CONSOLIDATING STATEMENTS OF INCOME  
BEECHNUT STREET, INC. AND SUBSIDIARIES  
Fiscal Year Ended May 31, 2011

	<b>Beechnut Street, Inc.</b>						
	<b>BSI</b>	<b>Fondren I</b>	<b>Fondren II</b>	<b>HBHC</b>	<b>HBHP I</b>	<b>Eliminations</b>	<b>Consolidated</b>
Operating Revenues and Support							
Rental revenue	\$ 98,900	\$ 1,095,259	\$ 439,530	\$ -	\$ 1,610,055	-	\$ 3,243,744
Investment income	-	-	-	-	283	-	283
Other	-	(457)	(1,272)	-	2,439	-	710
Total operating revenues and support	98,900	1,094,802	438,258	-	1,612,777	-	3,244,737
Operating expenses:							
Selling, general, and administrative	332,977	158,081	23,088	-	234,980	-	749,126
Plant	21,514	162,880	45,804	-	578,723	-	808,921
Depreciation expense	2,313	22,573	42,296	-	250,616	-	317,798
Taxes	29,526	132,461	55,387	-	20,715	-	238,089
Other	-	-	-	-	160	-	160
Total operating expenses	386,330	475,995	166,575	-	1,085,194	-	2,114,094
Operating income (loss)	(287,430)	618,807	271,683	-	527,583	-	1,130,643
Non-operating expenses:							
Interest expense	-	(27,503)	(32,951)	-	(305,105)	-	(365,559)
Casualty loss	-	-	-	-	-	-	-
Lease Expense (Paid To HBU)	-	(816,000)	(117,700)	-	(70,304)	-	(1,004,004)
Other intercompany income	-	-	-	-	-	-	-
Total non-operating expenses	-	(843,503)	(150,651)	-	(375,409)	-	(1,369,563)
Net income (loss)	(287,430)	(224,696)	121,032	-	152,174	-	(238,920)
Beginning equity (deficit)	(1,167,102)	(25,642)	850,368	(979)	532,094	(707,827)	(519,088)
Ending equity (deficit)	\$ (1,454,532)	\$ (250,338)	\$ 971,400	\$ (979)	\$ 684,268	\$ (707,827)	\$ (758,008)

See Report of Independent Certified Public Accountants

Consolidated Financial Statements and Report of Independent Certified Public Accountants

**Houston Baptist University and Subsidiary**

May 31, 2012 and 2011

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## Report of Independent Certified Public Accountants

Board of Trustees  
Houston Baptist University

We have audited the accompanying consolidated statements of financial position of Houston Baptist University and its subsidiary (collectively, the "University") as of May 31, 2012 and 2011, 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 as established by the American Institute of Certified Public Accountants 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 the 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Houston Baptist University and its subsidiary as of May 31, 2012 and 2011, 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 September 17, 2012 on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying supplemental schedules on pages 38 and 39, is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

*Fritz Roberts & Co., P.C.*

Houston, Texas  
September 17, 2012

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**  
May 31, 2012 and 2011

	2012	2011
<b>Assets</b>		
Cash and cash equivalents	\$ 6,046,857	\$ 14,571,088
Receivables, principally from students, net of allowance for doubtful accounts of \$2,584,258 and \$2,281,891 in 2012 and 2011, respectively	3,392,560	3,897,761
Pledges receivable, net	573,383	1,461,287
Prepayments, inventories and other assets	1,401,986	1,418,625
Investments	69,558,049	75,631,372
Escrow funds	1,816,765	-
Investment in plant assets, net	118,605,342	106,357,397
Interests in perpetual trusts held by others	3,570,219	3,873,119
Interests in trusts administered by others	61,805	69,833
Cash, restricted	4,853,755	920,000
<b>TOTAL ASSETS</b>	<b>\$ 209,880,721</b>	<b>\$ 208,200,482</b>
<b>Liabilities and Net Assets</b>		
Accounts payable and accrued liabilities	\$ 6,270,704	\$ 6,434,523
Deferred income	358,723	266,783
Deposits and agency funds	899,387	774,893
Interest rate swap	7,506,056	3,450,888
Notes payable	20,125,024	8,623,183
Bonds payable	50,180,000	51,160,000
<b>TOTAL LIABILITIES</b>	<b>85,339,894</b>	<b>70,710,270</b>
Net Assets:		
Unrestricted	68,430,791	72,621,060
Temporarily restricted	13,850,260	22,923,828
Permanently restricted	42,259,776	41,945,324
<b>TOTAL NET ASSETS</b>	<b>124,540,827</b>	<b>137,490,212</b>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b>\$ 209,880,721</b>	<b>\$ 208,200,482</b>

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF ACTIVITIES**  
Fiscal Years ended May 31, 2012 and 2011

	Unrestricted		Temporarily Restricted		Permanently Restricted		Total	
	2012	2011	2012	2011	2012	2011	2012	2011
Operating revenues and support								
Tuition and fees	\$ 54,877,299	\$ 52,360,202	\$ -	\$ -	\$ -	\$ -	\$ 54,877,299	\$ 52,360,202
Funded	(5,375,871)	(6,218,248)	-	-	-	-	(5,375,871)	(6,218,248)
Unfunded	(21,277,250)	(17,301,256)	-	-	-	-	(21,277,250)	(17,301,256)
Tuition and fees, net	28,224,178	28,840,698	-	-	-	-	28,224,178	28,840,698
Private gifts and grants:								
Baptist General Convention of Texas	513,440	419,990	-	-	-	-	513,440	419,990
Government grants & contracts	3,121,195	3,958,122	157,548	152,331	-	-	3,278,743	4,110,453
Gifts in kind	302,606	5,874	-	-	-	-	302,606	5,874
Other	681,444	855,353	1,789,622	3,000,126	-	-	2,471,066	3,855,479
Investment and endowment income	1,291,492	1,173,349	402,045	459,630	-	-	1,693,537	1,632,979
Sales and services of auxiliary enterprises	5,486,598	4,922,125	7,300	-	-	-	5,493,898	4,922,125
Net gain on operating asset	-	9,595,452	-	-	-	-	-	9,595,452
Other	189,638	225,577	-	-	-	-	189,638	225,577
BSI revenue	3,038,595	3,244,454	-	-	-	-	3,038,595	3,244,454
Net assets released from restriction:								
Satisfaction of program restrictions	4,494,572	3,161,979	(4,570,134)	(3,648,324)	75,562	486,345	-	-
Total operating revenues and support	47,343,758	56,402,973	(2,213,619)	(36,237)	75,562	486,345	45,205,701	56,853,081
Operating Expenses:								
Educational and general:								
Instructional	15,956,070	15,437,483	-	-	-	-	15,956,070	15,437,483
Academic support	3,383,925	3,802,992	-	-	-	-	3,383,925	3,802,992
Student services	3,910,869	4,031,230	-	-	-	-	3,910,869	4,031,230
Institutional support	10,593,878	11,213,111	-	-	-	-	10,593,878	11,213,111
Total education and general	33,844,742	34,484,816	-	-	-	-	33,844,742	34,484,816
Auxiliary enterprises	11,142,141	9,643,655	-	-	-	-	11,142,141	9,643,655
BSI expenses (excluding interest)	2,163,036	2,114,093	-	-	-	-	2,163,036	2,114,093
Total operating expenses	47,149,919	46,242,564	-	-	-	-	47,149,919	46,242,564

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



**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF ACTIVITIES - CONTINUED**  
Fiscal Years ended May 31, 2012 and 2011

	Unrestricted		Temporarily Restricted		Permanently Restricted		Total	
	2012	2011	2012	2011	2012	2011	2012	2011
<b>EXCESS (DEFICIT) OF OPERATING REVENUES OVER (UNDER) OPERATING EXPENSES</b>	<b>\$ 193,839</b>	<b>\$ 10,160,409</b>	<b>\$ (2,213,619)</b>	<b>\$ (36,237)</b>	<b>\$ 75,562</b>	<b>\$ 486,345</b>	<b>\$ (1,944,218)</b>	<b>\$ 10,610,517</b>
Non-operating activities:								
Contributions	-	-	-	-	227,931	470,813	227,931	470,813
Net assets released from restrictions:								
Satisfaction of capital acquisition restrictions	2,108,102	4,292,964	(2,108,102)	(4,349,846)	-	56,882	-	-
Interest on indebtedness	(1,849,656)	(1,977,801)	-	-	-	-	(1,849,656)	(1,977,801)
Change in value of split interest agreements	-	-	(321,887)	564,671	10,959	50,135	(310,928)	614,806
Unrealized gain/(loss) on investments	(5,471,747)	(844,826)	(5,685,080)	6,813,246	-	-	(1,156,827)	5,968,420
Realized gain/(loss) on sale of investments	829,193	(17,886)	1,255,120	794,365	-	-	2,084,313	776,479
<b>Total from non-operating activities</b>	<b>(4,384,108)</b>	<b>1,452,451</b>	<b>(6,859,949)</b>	<b>3,822,436</b>	<b>238,890</b>	<b>577,830</b>	<b>(11,005,167)</b>	<b>5,852,717</b>
Change in net assets	(4,190,269)	11,612,860	(9,073,568)	3,786,199	314,452	1,064,175	(12,949,385)	16,463,234
Net assets - beginning of year	72,621,060	61,008,200	22,923,828	19,137,629	41,945,324	40,881,149	137,490,212	121,026,978
Net assets - end of year	<u>\$ 68,430,791</u>	<u>\$ 72,621,060</u>	<u>\$ 13,850,260</u>	<u>\$ 22,923,828</u>	<u>\$ 42,259,776</u>	<u>\$ 41,945,324</u>	<u>\$ 124,540,827</u>	<u>\$ 137,490,212</u>

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
Fiscal Years ended May 31, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Change in net assets	\$ (12,949,385)	\$ 16,463,234
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Realized (gain) on sale of investments	(2,084,313)	(776,479)
Unrealized loss/(gain) on investments	7,101,659	(6,940,859)
Loss from bond interest swap	4,055,168	972,439
Change in value of split-interest agreements and other trusts	310,928	(614,806)
Reinvested interest and dividends	(546,909)	(613,523)
Bad debt expense	1,171,307	775,173
Depreciation and amortization on investment in plant assets	4,323,625	4,213,271
Proceeds from contributions restricted for long-term investment	(227,931)	(470,813)
Changes in:		
Receivables, net	(666,106)	(151,605)
Pledges receivable, net	887,904	1,036,741
Prepayments, inventories, and other assets	16,639	10,189
Accounts payable and accrued liabilities	(122,274)	520,205
Deposits and agency funds	124,494	(385,760)
Deferred income	91,940	86,587
Net cash provided by operating activities	1,486,746	14,123,994
Cash flows from investing activities:		
Purchases of investments	(13,519,597)	(4,813,228)
Proceeds from sale of investments	15,122,483	3,166,906
Purchases of plant assets	(16,571,575)	(2,115,737)
Contractual payments on annuities	(41,545)	(39,969)
Net cash (used in) investing activities	(15,010,234)	(3,802,028)
Cash flows from financing activities:		
Proceeds from contributions restricted for long-term investment	227,931	470,813
Cash, restricted	(5,750,520)	(920,000)
Payments on bonds	(980,000)	(940,000)
Proceeds from new notes	12,076,530	-
Payments on notes payable	(574,684)	(549,994)
Net cash provided by (used in) financing activities	4,999,257	(1,939,181)
Net (decrease) increase in cash and cash equivalents	(8,524,231)	8,382,785
Cash and cash equivalents at beginning of year	14,571,088	6,188,303
Cash and cash equivalents at end of year	<u>\$ 6,046,857</u>	<u>\$ 14,571,088</u>
Noncash transactions		
Retirement of plant assets	\$ 199,652	\$ 20,711

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

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### **1. General**

Houston Baptist University (the "University") is a private, non-profit institution of higher education based in Houston, Texas. The University is affiliated with the Baptist General Convention of Texas and provides education and training services primarily for students at the undergraduate and graduate levels. The University is a non-profit organization exempt from Federal income taxes under 501(a) as an organization described in Section 501(c)(3) of the Internal Revenue Code. The University is primarily supported by tuition and fees from students.

Beechnut Street, Inc. ("BSI") is a wholly-owned for-profit subsidiary of the University's Quasi Endowment Fund. BSI was established to hold and operate certain real estate and other investments. It owns a 21,953 square foot retail center and two adjoining ground leases situated on approximately 6.7 acres located on the northeast perimeter of the campus, known as Fondren II. In November 2007, BSI purchased Fondren I which consists of two in-line strip retail buildings containing 173,355 square feet, a freestanding retail store containing 9,000 square feet and one pad site improved with approximately 3,200 square feet of restaurant located on 15.2802 acres of land on the southeast corner of Fondren and US 59.

HB Housing Partnership I, LTD. (the "Partnership" or "HBHPI") is a Texas Limited Partnership that operates the student housing apartment complex known as Husky Village. The Partnership commenced operations in March 1997 with two limited partners, HB Housing Corp ("HBHC"), a Texas Corporation, and BSI. The Partnership entered into an amended ground lease dated February 2003, with Houston Baptist University and constructed a 143 unit apartment complex in three phases, designed and financed by the Partnership, that houses students attending Houston Baptist University. During the year ended August 2004, BSI purchased the ownership interest of HBHC and the Partnership, along with HBHC, became wholly-owned by BSI.

The balance sheet and statement of income of the Partnership, HBHC, and BSI prior to consolidation with the University are included in the supplemental schedules to this report.

Bradshaw Recreation Center, Inc. ("BRC"), a non-profit organization under Section 501(c)(3) of the Internal Revenue Code, was formed in December 2011 to manage the operations of the Bradshaw Fitness Center. BRC is a wholly-owned subsidiary of Houston Baptist University and is in the process of applying for tax exemption at the state and federal levels.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES— Continued

##### **2. Basis of Presentation**

The consolidated financial statements include the accounts of the various academic and administrative divisions of the University, the Partnership, BSI and BRC. Inter-company balances and transactions are eliminated in consolidation.

Revenues, expenses, gains and losses are recorded on the accrual basis of accounting and are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the University are classified and reported as follows:

Permanently restricted - Net assets subject to donor-imposed stipulations that they be maintained permanently by the University. Generally, the donors of these assets permit the University to use all or part of the income earned on related investments for general or specific purposes. The income is included in temporarily restricted or unrestricted net assets as applicable.

Temporarily restricted - Net assets subject to donor-imposed stipulations that may or will be met either by actions of the University and/or the passage of time.

Unrestricted - Net assets that are not subject to donor-imposed stipulations.

Revenues from sources other than contributions are reported as increases in unrestricted net assets. Expenses are reported as decreases in unrestricted net assets. Gains or losses on investments are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulations or by law. Expirations of temporary restrictions recognized on net assets (e.g., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications from temporarily restricted net assets to unrestricted net assets. Temporary restrictions on gifts to acquire long-lived assets are considered met in the period in which the assets are acquired or placed in service.

Contributions, including unconditional promises to give, are recognized as revenues in the period received. Contributions of assets other than cash are recorded at their estimated fair value at the date of gift. Contributions to be received after one year are discounted at the three year treasury note rate. Amortization of the discount is recorded as additional contribution revenue in accordance with donor-imposed restrictions, if any, on the contributions. Allowance is made for uncollectible contributions based upon management's judgment and analysis of the creditworthiness of the donors, past collection experience and other relevant factors.

##### **3. Cash and Cash Equivalents**

Cash equivalents include time deposits, certificates of deposit, and highly liquid debt instruments with maturities of three months or less at date of acquisition.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

##### **4. Escrow Funds**

Escrow funds represent proceeds received from the note payable with a bank designated for the purchase and installation of equipment to be installed in various campus buildings and facilities.

##### **5. Accounts Receivable and Related Allowance for Doubtful Accounts**

Accounts receivable relate primarily to receivables from students. Tuition and registration charges relating to future semesters are recorded as deferred revenue when collected. Uncollected future fees are not recorded until the semester begins.

The estimated allowances for uncollectible accounts and notes receivable are accounted for using the reserve method. Under this method, allowances are maintained at a level which, in the judgment of management, is adequate to meet the present and potential risks of uncollectibility of the accounts and notes receivable. Management's judgment is based on a variety of factors, which include experience related to charge-offs and recoveries, and scrutiny of individual accounts and notes receivable. Amounts deemed by management to be uncollectible are charged to expense. Recoveries on receivables previously charged-off are credited to expense. Provisions for receivable losses are charged to expense and credited to the allowance for doubtful accounts.

##### **6. Inventories**

Inventories, which consist primarily of textbooks, clothing, gifts and supplies are stated at cost and are expensed using the first in, first out method.

##### **7. Investments**

Investments in corporate stocks and bonds are stated at quoted market value. Oil and gas royalty interests are valued by an independent appraiser. Other investments consist of a long term certificate of deposit which is carried at cost. Real estate is stated at fair market value as determined by independent appraisers. All real estate investments are held primarily for campus expansion and to function as sources of Quasi Endowment Fund income for the University. Real estate investment income is recognized net of related direct expenses. Investments in private investment funds are carried at net asset value as a practical expedient for determining fair values. The University may redeem its investments in private funds annually with 95 days notice.

Unrealized gains and losses resulting from increases and decreases in such fair market values are recognized during the period in which the change occurs.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued**

Pooled endowment and similar funds are invested on the basis of a total return policy to provide income and to realize appreciation in investment values. Amounts distributed from endowment funds to support operations for general or specific purposes are based on the trailing twelve quarter average market value of the investment pool.

#### **8. Restricted Cash**

Under the swap agreement between the University and Bank of America, the University is required to maintain a specified cash balance with the bank as collateral, if the swap liability exceeds a certain threshold. As of May 31, 2012 and 2011, the required balance was \$4,853,755 and \$920,000, respectively.

#### **9. Concentration of Credit Risk**

The University places its cash and cash equivalents with well capitalized financial institutions, which at times may exceed federally insured limits. The University has not experienced any losses of such accounts.

#### **10. Investment in Plant Assets**

Investment in plant assets are stated at cost less accumulated depreciation and amortization. Cost is determined by the purchase price or fair value, if acquired by gift. Campus land, construction in progress, and art and historical objects are not subject to depreciation or amortization. The University capitalizes items in excess of \$2,500 with a useful life of at least three years. Leasehold improvements are amortized over the shorter of the lease term or useful life of the asset. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets.

#### **11. Perpetual Trusts**

The University is the beneficiary of certain perpetual trusts held and administered by others, specifically the Baptist Foundation of Texas. The present values of the estimated future cash receipts from the trusts are recognized as assets and contribution revenues at the dates the trusts are established. Distributions of income from the trusts are recorded as contributions and the carrying value of the assets is adjusted for changes in the estimates of future receipts.

#### **12. Derivative Instruments and Hedging Activities**

The University follows FASB Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*, which establishes accounting and reporting standards for derivative instruments. Specifically, the standard requires all entities, including not-for-profit organizations, to recognize all derivatives as either assets or liabilities in their statement of financial position and to measure such instruments at fair value. Changes in the fair value of derivative financial instruments are recognized periodically as changes in net assets.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

##### 13. Functional Expenses

Costs related to the operation and maintenance of physical plant, including depreciation and amortization of plant assets, are allocated to program and supporting activities based upon the percentage of total assets utilized by the applicable program or activity (see Note G).

##### 14. Advertising Costs

Advertising costs are expensed as incurred. Advertising costs were approximately \$598,000 and \$681,000 for 2012 and 2011, respectively, and were charged to operating expenses.

##### 15. Operating Revenues and Support and Non-operating Activities

Revenues and expenses included in operating revenues and support relate primarily to the University's educational mission. Non-operating activities include contributions to endowments, interest on indebtedness, and gains and losses on valuation and sales of assets.

##### 16. 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 judgments that affect the reported amounts of assets and liabilities and disclosures of contingencies at the date of the financial statements and revenues and expenses recognized during the reporting period. Significant estimates made by management include the estimated fair value of investments other than marketable securities (primarily real estate), the allowance for doubtful accounts, discounts on pledge receivables, the fair value of investments in perpetual trusts held by others, the estimated payable for life annuitants, and the fair value of the interest rate swap. Actual results could differ from those estimates.

##### 17. Fair Value Option

FASB ASC 825 *Financial Instruments* permits entities to choose to measure certain financial instruments and other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. As permitted by the standard, management elects not to elect the fair value option, for the financial assets and liabilities that had not been previously carried at fair value.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES –  
Continued**

**18. Income Taxes**

The University follows ASC 740 which requires the evaluation of how tax positions should be recognized, measured, presented, and disclosed in the financial statements. The standard requires the evaluation of tax positions taken or expected to be taken in the course of preparing tax returns to determine whether the tax positions are “more-likely-than-not” of being sustained by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. The adoption of ASC 740 did not have an effect on the University’s net asset value, financial position or results of activities. As of May 31, 2012 and 2011 and for the years then ended, the University and its subsidiary, BSI, did not have an asset or liability for any unrecognized tax positions. Management’s determinations regarding ASC 740 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an on-going analysis of tax laws, regulations and interpretations thereof.

**19. Recently Issued Accounting Standards**

Recent accounting pronouncements issued by the Financial Accounting Standards Board (FASB) did not or are not believed by management to have a material impact on the University’s present or future financial statements.



**Houston Baptist University and Subsidiary**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**NOTE B - ALLOWANCE FOR DOUBTFUL ACCOUNTS**

An allowance for doubtful accounts is provided against student receivables as discussed in Note A. The allowance for doubtful accounts at May 31, consists of the following:

	<u>2012</u>	<u>2011</u>
Allowance for doubtful accounts - beginning of year	\$ 2,282,891	\$ 1,950,598
Add: provision for doubtful accounts	1,171,307	775,173
Less: accounts written off	<u>(869,940)</u>	<u>(442,880)</u>
Allowance for doubtful accounts - end of year	<u>\$ 2,584,258</u>	<u>\$ 2,282,891</u>

The provision for doubtful accounts is included in institutional support on the consolidated statements of activities.

**NOTE C - PLEDGES RECEIVABLE, NET**

Pledges receivable, net, at May 31, consists of the following:

	<u>2012</u>	<u>2011</u>
Unconditional promise expected to be collected in:		
Less than one year	\$ 438,606	\$ 611,921
One year to five years	136,067	856,100
	574,673	1,468,021
Less unamortized discount	<u>(1,290)</u>	<u>(6,734)</u>
Total pledges receivable, net	<u>\$ 573,383</u>	<u>\$ 1,461,287</u>

Pledges receivable were discounted using rates ranging from .35% to .79%.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE D - INVESTMENTS

Investments at fair value, at May 31, consist of the following:

	2012	2011
Common stocks	\$ 1,117,631	\$ 1,175,271
Bonds	11,113,924	7,356,078
Mutual funds	25,194,784	34,413,900
Private investment fund	5,801,869	5,052,074
Real estate	24,731,432	26,117,636
Oil and gas royalty interests	1,533,409	1,451,413
Other investments	65,000	65,000
Total	\$ 69,558,049	\$ 75,631,372

The University nets investment fees against investment and endowment income. Investment fees were approximately \$220,000 and \$236,000 for the years ended May 31, 2012 and 2011, respectively.

#### NOTE E - RISKS AND UNCERTAINTIES

The University invests in various investment securities. Investment securities are exposed to various risks, such as interest rate, overall market volatility and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the University's account balances and the amounts reported in the statements of financial position.

#### NOTE F - SALE OF REAL ESTATE

In 2003 and 2005, the University sold the right to use certain real estate assets held for investment (parcel 1 and parcel 2) for approximately \$4,123,000 and \$941,000, respectively. Under the terms of these agreements, the land and improvements will revert back to the University in the year 2048 and 2020, respectively.

These transactions have been recorded as a sale of the property since the University will not have the right to the use of this land for approximately 44 and 14 years, respectively. Because the land and buildings will revert to the University, the current fair value of the property is being accrued into the financial statements over the 44 and 14 year periods prior to the reversion of the land and improvements. On December 15, 2011, the University purchased building, equipment and land related to parcel 1 for \$10,000,000, with the intention of using the building as a student recreation facility known as the Bradshaw Fitness Center. The land, building and equipment related to this purchase are presented in investment in plant assets on the consolidated statements of financial position. The cumulative amount accrued as an asset and income for both parcels for the year ended May 31, 2011 was approximately \$1,192,000, and is reflected in investments on the consolidated financial statements of financial position. The cumulative amount accrued as an asset and income for parcel 2 for the year ended May 31, 2012 was approximately \$521,000.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE G - INVESTMENT IN PLANT ASSETS, NET

Investment in plant assets, net, consists of the following at May 31:

	Estimated Useful Life	2012	2011
Buildings	20 - 50 years	\$ 107,618,115	\$ 100,559,799
Furniture, equipment, and library books	3 - 10 years	19,753,051	16,315,009
Land improvements	10 - 20 years	15,488,271	14,296,732
Software	10 years	2,317,188	2,154,409
Leasehold improvements	10 - 20 years	1,714,292	1,616,585
Vehicles	5 years	427,536	346,361
		147,318,453	135,288,895
Less accumulated depreciation and amortization		(42,470,783)	(37,947,506)
Campus land		6,360,248	2,135,654
Art and historical objects		5,908,305	5,602,855
Construction in progress		1,489,119	1,277,499
Total investment in plant assets, net		<u>\$ 118,605,342</u>	<u>\$ 106,357,397</u>

Depreciation and amortization expense for the years ended May 31, 2012 and 2011 was \$4,323,625 and \$4,213,271, respectively, and has been allocated to functional programs and supporting activities as follows:

Operation of plant expense for the years ended May 31, 2012 and 2011 was \$4,794,527 and \$4,653,621, respectively, and has been allocated to functional programs and supporting activities as follows:

	Depreciation and Amortization Expense		Operation of Plant Expense	
	2012	2011	2012	2011
Instructional	\$ 1,468,201	\$ 1,234,504	\$ 1,437,403	\$ 1,218,413
Academic support	310,828	381,926	304,314	376,948
Student services	223,434	274,053	221,980	270,481
Institutional support	510,819	632,914	500,097	624,665
Auxiliary enterprises	1,500,578	1,372,076	1,491,845	1,354,192
BSI	309,765	317,798	838,888	808,922
Total	<u>\$ 4,323,625</u>	<u>\$ 4,213,271</u>	<u>\$ 4,794,527</u>	<u>\$ 4,653,621</u>

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE H - DEBT

	May 31, 2012	May 31, 2011
<b><u>Bonds</u></b>		
Crawford Education Facilities Corporation ("CEFC") bonds, issued November 2007 in the amount of \$53,000,000 due in annual installments ranging from \$900,000 to \$3,220,000, beginning December 1, 2009 thru December 1, 2037. The interest rate is Securities Industry and Financial Markets Association ("SIFMA") plus 0.825%. On November 1, 2010, the bonds were remarketed publicly backed by a letter of credit from a bank. Under this agreement, the interest rate is SIFMA. At May 31, 2011, the interest rate was .18%. The bonds are secured by 6.686 acres of land, including improvements, and the future revenues of the University.	50,180,000	51,160,000
<b><u>Notes Payable</u></b>		
A note payable with a bank dated November 20, 2004 of \$7,181,499, requiring 83 monthly principal and interest payments of \$41,188 with the balance due at the maturity on November 20, 2011. The note bears interest at 5% and is secured by a ground lease on 7.6660 acres and all tenant rents and leases. Effective December 2011 the note was refinanced to extend the maturity date to November 20, 2029. The refinanced note bears interest at 3.25% and requires monthly payments of principal and interest of \$35,880.	5,719,115	5,919,942
A note payable with a bank dated November 1, 2000 of \$2,500,000, requiring monthly payments of principal and interest of \$24,795 plus the balance at maturity, bearing interest at LIBOR plus 1.2%. The note was refinanced August 10, 2007 in the amount of \$3,000,000 requiring 60 monthly payments of principal and interest of \$26,965, commencing August 28, 2007, which assumes an effective interest rate of 7% over a 15 year amortization period. The note bears interest at LIBOR plus 1.2%, matures August 12, 2012 and is secured by the 1 <sup>st</sup> lien on Fondren II and the ground leases from the tenants. The note is guaranteed by the University. Effective August 28, 2012, the note was refinanced. The new note bears interest at the greater of the U.S. Prime Rate (as published by the Wall Street Journal) or 3.25%, and requires 84 monthly payments of principal and interest of \$23,452 beginning September 28, 2012 with all unpaid principal and accrued interest due at maturity on August 28, 2019.	1,757,004	2,052,627

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE H - DEBT – Continued

A note payable with a bank dated February 9, 2005 of \$500,000, requiring 84 monthly payments of principal and interest of \$2,948 with the balance due at the maturity on February 20, 2012. The note bears interest at 5% and is secured by a ground lease on 7.6660 acres and all tenant rents and leases. Effective December 2011 the note was refinanced to extend the maturity date to November 20, 2029. The refinanced note bears interest at 3.25% and requires monthly payments of principal and interest of \$2,579.

411,082

425,470

A note payable with a non-profit organization dated January 1, 2012 of \$9,400,000, requiring 12 quarterly interest only payments through December 31, 2014. Quarterly principal and interest payments of \$143,138 begin March 31, 2015 through maturity at December 15, 2021 at which time any unpaid principal and accrued interest is due in full. The note bears interest at 4.5% and is secured by certain real estate property and the Bradshaw Recreation Center (BRC).

9,400,000

-

A note payable with a bank dated March 2, 2012 of \$2,676,530, requiring 29 quarterly principal payments of \$55,762 plus interest with the balance due at the maturity on March 2, 2019. The note bears interest at 4.85% and is secured by all unrestricted gross revenues; all interest, dividends, cash, instruments and other property; escrow funds; and all other proceeds.

2,676,530

-

### Capital Leases

A capital lease arrangement with a leasing company dated August 14, 2009 of \$201,000, requiring 60 monthly payments of principal and interest of \$4,475 ending September 31, 2014.

101,470

139,845

A capital lease arrangement with a bank dated July 27, 2009 of \$129,792, requiring 60 monthly payments of principal and interest of \$2,599 ending July 31, 2014.

59,823

85,299

Total notes payable and capital leases

20,125,024

8,623,183

Total debt

\$ 70,305,024

\$ 59,783,183

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE H - DEBT – Continued

Future minimum payments under this debt are as follows:

May 31,	Bonds	Notes payable	Capital leases	Total
2013	\$ 1,035,000	\$ 2,246,238	\$ 84,887	\$ 3,366,125
2014	1,080,000	498,016	84,887	1,662,903
2015	1,130,000	544,474	11,544	1,686,018
2016	1,180,000	669,806	-	1,849,806
2017	1,240,000	686,964	-	1,926,964
Thereafter	44,515,000	15,318,233	-	59,833,233
Subtotal	50,180,000	19,963,731	181,318	70,325,049
Less amounts representing interest	-	-	(20,025)	(20,025)
Total	<u>\$ 50,180,000</u>	<u>\$ 19,963,731</u>	<u>\$ 161,293</u>	<u>\$ 70,305,024</u>

The interest expense on notes and bonds payable for the years ending May 31, 2012 and 2011, respectively, was approximately \$1,850,000 and \$1,978,000. The interest paid on notes and bonds payable for the years ending May 31, 2012 and 2011, respectively, was approximately \$1,790,000 and \$2,019,000.

The Master Bond Agreement contains a swap provision. Effective February 1, 2008, the University executed two interest rate swaps in the amounts of \$26,000,000 and \$12,000,000. The swaps bear interest at 3.8275% and 3.395% and mature December 1, 2027 and February 1, 2018, respectively. The University entered into the agreement to lock in fixed interest rates on the variable rate debt and is not using the agreements for speculative purposes. The amount recorded in net assets for the changes in value of the instrument was an unrealized loss of \$4,055,000 and \$972,000, at May 31, 2012 and 2011, respectively, and is included in unrealized gain (loss) on sale of investments in the consolidated statements of activities.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts and estimated fair values of the University's financial instruments are as follows:

	2012		2011	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:				
Cash and cash equivalents	\$ 6,046,857	\$ 6,046,857	\$ 14,571,088	\$ 14,571,088
Receivables - principally from students, net	3,392,560	3,392,560	3,897,791	3,897,791
Pledges receivable, net	573,383	573,383	1,461,287	1,461,287
Investments:				
Common stocks	1,117,631	1,117,631	1,175,271	1,175,271
Bonds	11,113,924	11,113,924	7,356,078	7,356,078
Mutual funds	25,194,784	25,194,784	34,413,900	34,413,900
Private investment fund	5,801,869	5,801,869	5,052,074	5,052,074
Real estate	24,731,432	24,731,432	26,117,636	26,117,636
Oil and gas royalty interests	1,533,409	1,533,409	1,451,413	1,451,413
Certificate of deposit	65,000	65,000	65,000	65,000
Interests in perpetual trusts held by others	3,570,219	3,570,219	3,873,119	3,873,119
Interest in trusts administered by others	61,805	61,805	69,833	69,833
Financial liabilities:				
Accounts payable and accrued liabilities	6,270,704	6,270,704	6,434,523	6,434,523
Deposits and agency funds	899,387	899,387	774,893	774,893
Interest rate swap	7,506,056	7,506,056	3,450,888	3,450,888
Bonds payable	50,180,000	50,180,000	51,160,000	51,160,000
Notes payable	19,963,731	19,491,549	8,398,039	8,351,751
Capital leases payable	161,293	161,293	225,144	225,144

The methods and assumptions used to estimate the fair value of each class of financial instruments are as follows:

#### Cash and cash equivalents

The carrying amount approximates fair value due to the short maturity of those instruments.

#### Receivables- principally from students - net

The carrying amount approximates fair value based on the short maturities of accounts receivable.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued**

Pledges receivable - net

The fair value of pledges receivable is based on the discounted value of expected future cash flows.

Investments

Corporate stocks and bonds and real estate are carried at market value; therefore, the carrying value approximates fair value. Other investments consist of a long-term certificate of deposit carried at amortized cost which approximates fair value.

Interests in perpetual trusts held by others

The interests in trusts held by others are carried at fair value which is determined using the net asset value of shares held by the trusts.

Interests in trusts administered by others

The interests in trusts administered by others are carried at fair value which is determined using the net asset value of shares held by the trusts.

Accounts payable, accrued liabilities, deposits and agency funds

The carrying amount approximates fair value because of the short maturity of the financial instruments.

Bonds payable

The carrying value approximates fair value based on the variable interest rates of the bonds payable.

Interest rate swap

The interest rate swap is carried at fair value as determined by using current market rates.



## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

##### Notes payable

The estimated fair value of notes payable is based on discounting future cash flows using current interest rates at which similar loans could be obtained for the same remaining maturities.

The University follows the fair value guidance for its financial assets and liabilities. The guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability, in an orderly transaction between market participants at the measurement date. The guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The three levels of inputs that may be used to measure fair value:

- Level 1: Inputs based on quoted market prices for identical assets or liabilities in active markets at the measurement date.
- Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. The inputs are unobservable in the market and significant to the instruments valuation.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

The following table classifies the University's financial assets and liabilities measured at fair value on a recurring basis as of May 31, 2012:

Description	May 31, 2012	Level 1	Level 2	Level 3
<b>Financial assets:</b>				
Investments:				
Common stocks by sector:				
Basic material	\$ 187,458	\$ 187,458	\$ -	\$ -
Financial	345,051	345,051	-	-
Services	402,691	402,691	-	-
Other	182,431	182,431	-	-
Bonds:				
US Government	5,879,732	5,879,732	-	-
US Corporate	3,122,122	-	3,122,122	-
Mutual funds:				
Stocks	25,194,784	11,729,306	13,465,479	-
Bonds	2,112,070	-	2,112,070	-
Certificate of deposit	65,000	65,000	-	-
Private investment fund	5,801,869	-	5,801,869	-
Real estate	24,731,432	-	-	24,731,432
Oil and gas royalty interest	1,533,409	-	-	1,533,409
Interest in perpetual trusts held by others	3,570,219	-	3,570,219	-
Interests in trusts administered by others	61,805	-	61,805	-
Total investments at fair value	<u>\$ 73,190,073</u>	<u>\$ 18,791,669</u>	<u>\$28,133,564</u>	<u>\$ 26,264,841</u>
<b>Financial liabilities:</b>				
Interest rate swap	<u>\$ 7,506,056</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 7,506,056</u>

The University has made capital commitments to the investment manager of the alternative investment of \$5,434,000. As of May 31, 2012, all of this capital commitment has been funded.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

The following table classifies the University's financial assets and liabilities measured at fair value on a recurring basis as of May 31, 2011:

Description	May 31, 2011	Level 1	Level 2	Level 3
<b>Financial assets:</b>				
Investments:				
Common stocks by sector:				
Basic material	\$ 204,241	\$ 204,241	\$ -	\$ -
Financial	336,036	336,036	-	-
Services	336,566	336,566	-	-
Other	298,428	298,428	-	-
Bonds:				
US Government	5,253,789	5,253,789	-	-
US Corporate	2,102,289	-	2,102,289	-
Mutual funds:				
Stocks	32,496,831	19,619,700	12,877,131	-
Bonds	1,917,069	-	1,917,069	-
Certificate of deposit	65,000	65,000	-	-
Private investment fund	5,052,074	-	5,052,074	-
Real estate	26,117,636	-	-	26,117,636
Oil and gas royalty interest	1,451,413	-	-	1,451,413
Interest in perpetual trusts held by others	3,873,119	-	3,873,119	-
Interests in trusts administered by others	69,833	-	69,833	-
Total investments at fair value	<u>\$ 79,574,324</u>	<u>\$ 26,113,760</u>	<u>\$ 25,891,515</u>	<u>\$ 27,569,049</u>
<b>Financial liabilities:</b>				
Interest rate swap	<u>\$ 3,450,888</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,450,888</u>

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

The schedule below reconciles the opening balance to the closing balance for the year ended May 31, 2012 for the items on the previous table which have been classified as Level 3:

	Real estate	Oil and gas Royalty interests	Interest rate swap
Balance, beginning of year	\$ 26,117,636	\$ 1,451,413	\$ (3,450,888)
Total gains (losses)			
Included in realized/unrealized	799,721	81,996	(4,055,168)
Included in unrealized gain/(loss) on investments	(1,386,205)		
Sales	(799,720)		
Balance, end of year	<u>\$ 24,731,432</u>	<u>\$ 1,533,409</u>	<u>\$ (7,506,056)</u>

The schedule below summarizes the activity for the year ended May 31, 2011 for the items on the previous table which have been classified as Level 3:

	Real estate	Oil and gas Royalty interests	Interest rate swap
Balance, beginning of year	\$ 26,459,915	\$ 1,254,500	\$ (2,478,449)
Total gains (losses)			
Included in unrealized gain/(loss) on investments	(342,279)	196,913	(972,439)
Balance, end of year	<u>\$ 26,117,636</u>	<u>\$ 1,451,413</u>	<u>\$ (3,450,888)</u>

Total Level 3 gains or losses above are all included in the consolidated statements of activities, and all relate to financial assets and liabilities still held at year end.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE J - RETIREMENT PLAN AND TUITION REIMBURSEMENT**

In 1963, the University established a retirement plan for all regular full-time faculty members and administrative staff. In compliance with the Tax Reform Act of 1986, the plan (a defined contribution plan) was amended in January 1989. Employees who complete one year of service and who work a total of 1,000 hours during a calendar year are eligible to participate. Upon an employee reaching eligibility, contributions are made to the plan by the University in an amount equal to 5% of the participant's salary. In addition, the University will contribute an amount equal to the participant's contribution, not to exceed 2.5% of the participant's salary. Effective June 1, 2009, the University contribution has been temporarily discontinued.

Employees may make voluntary contributions up to the limit allowed by law. Effective January 1, 1992, retirement benefits for new employees vest 100% after five years of employment. Participants in the plan prior to January 1, 1992 are fully vested from the time of initial contribution. Participants can elect to retire at various ages under the plan with the earliest being at age 55. Contributions to the Plan by the University were approximately \$823,000 and \$821,000 for 2012 and 2011, respectively.

Effective January 1, 2007 in an effort to encourage long-term continuous service, faculty and staff members who have completed ten continuous years of fulltime employment at the University are eligible for tuition benefits for their children to attend other universities. An eligible faculty or staff member may receive up to 80% of the tuition remission amount that would have been received had the child attended the University. For the years ended May 31, 2012 and 2011 approximately \$19,000 and \$44,000 were expensed, respectively. After the fall term of 2009, this long-term tuition benefit was discontinued, though some grandfathered benefits are still being paid.

Also, faculty or staff members who have completed six months of continuous fulltime employment at the University prior to the first day of the academic semester are eligible for tuition benefits for themselves as well as eligible spouses and children. For the years ended May 31, 2012 and 2011, respectively, approximately \$453,000 and \$498,000 were expensed for faculty, staff, and their spouses and children.

#### **NOTE K - TRUST FUNDS HELD BY OTHERS**

The University is the beneficiary of several trust funds administered primarily by the Baptist Foundation of Texas. No provision has been made for releasing trust principal to the University, except for the payment of specific capital improvements authorized under specified conditions of each trust. The amount of original trust principal has a fair value of approximately \$3,632,000 and \$3,943,000 on May 31, 2012 and 2011, respectively. Income distributions from these funds were approximately \$260,000 and \$207,000 in 2012 and 2011, respectively.

The University is the beneficiary of trust funds from various estates. Substantially all distributions from such trust funds are royalty income and totaled approximately \$200,000 and \$254,000 in 2012 and 2011, respectively, and are recorded in investment and endowment income.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE L – NET ASSETS

Temporarily restricted net assets consist of the following at May 31:

	2012	2011
Pledges receivable principally for student, facilities and campus enhancements	\$ 516,813	\$ 1,293,464
Net cumulative income from endowment funds – (including unrealized gains) primarily for scholarships	10,440,822	16,545,974
Funds administered by others – life annuity funds	(13,757)	69,833
Trusts held by others	1,557,543	1,871,402
Student scholarships and loans	368,892	546,171
Equipment, renovations and operations	1,092,394	2,662,868
Life annuity funds	(112,447)	(65,884)
Total	<u>\$ 13,850,260</u>	<u>\$ 22,923,828</u>

Permanently restricted net assets and the purpose for which the income from those net assets is expendable are as follows:

	2012	2011
General endowment funds	\$ 34,003,720	\$ 33,849,711
Endowed academic scholarship funds	7,770,646	7,685,766
Life annuity funds	258,064	182,501
Student loan funds	227,346	227,346
Total	<u>\$ 42,259,776</u>	<u>\$ 41,945,324</u>

### NOTE M - DEVELOPMENT EXPENSES

The University incurred expenses totaling approximately \$1,068,000 and \$784,000 for the years ended May 31, 2012 and 2011, respectively, related to development and fund-raising. Such amounts are included in institutional support expenses in the accompanying consolidated statements of activities.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE N - COMMITMENTS AND CONTINGENCIES

The University is the lessor of operating leases with third parties expiring in various years through 2022. Minimum future rental income under non-cancelable operating leases having remaining terms in excess of one year as of May 31 are:

	HBU	BSI	Total
2013	\$ 524,753	\$ 1,375,518	\$ 1,900,271
2014	306,304	935,001	1,241,305
2015	197,375	621,855	819,230
2016	111,851	371,751	483,602
2017	111,851	180,451	292,302
Thereafter	479,994	419,034	899,028
Total minimum future rental income	<u>\$ 1,732,128</u>	<u>\$ 3,903,610</u>	<u>\$ 5,635,738</u>

Rental income for the years ended May 31, 2012 and 2011 was approximately \$2,232,000 and \$2,520,000, respectively, and has been included in the investment and endowment income and BSI revenue on the consolidated statements of activities.

The University participates in various federal loan programs. In March 2010, Congress passed the Health Care and Education Reconciliation Act of 2010. Under this act, the federal government stopped giving subsidies to private banks to give out federally insured loans. Instead, loans will be administered directly by the Department of Education. Subsequent to the passing of this Act, the Federal Direct Loan Program is the sole government-backed loan program in the United States, replacing the Federal Family Education Loan Program. The amount of loans disbursed under the Federal Family Education Loan Program for the years ended May 31, 2012 and 2011 was approximately \$0 and \$31,000, respectively. The amount of loans disbursed under the Direct Loan Program for the years ended May 31, 2012 and 2011 was approximately \$15,423,000 and \$15,687,000, respectively. Amounts questioned as a result of audits, if any, may result in the University purchasing the loan(s) from the lender as the loan(s) may have lost its (their) guaranteed status. Management believes that such amounts, if any, would be immaterial to the financial statements.

Activity of the Pell Grant program is not reflected in the consolidated statements of activities as the transactions are considered to be agency transactions. Students received approximately \$3,799,000 and \$4,271,000 from the Federal Pell Grant programs during fiscal years 2012 and 2011, respectively.

The University participates in various federal Title IV financial aid programs. The Department of Education requires private nonprofit institutions to demonstrate financial responsibility by meeting certain ratio requirements. The University was in compliance with these requirements at May 31, 2012 and May 31, 2011.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE O - ENDOWMENTS**

The University's endowment consists of approximately 365 individual funds established for a variety of purposes. Its endowment includes both donor-restricted endowment funds and funds designated by the Board of Trustees to function as endowments. As required by generally accepted accounting principles ("GAAP"), 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 Board of Trustees of the University has interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value 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 donated 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 in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization 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 donor-restricted 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 policy of the University.



**Houston Baptist University and Subsidiary**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**NOTE O - ENDOWMENTS - Continued**

**2012**

**Endowment Net Asset Composition by Type of Fund as of May 31, 2012**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$ 11,872,160	\$42,259,776	\$54,131,936
Board-designated endowment Funds	<u>22,988,423</u>	<u>-</u>	<u>-</u>	<u>22,988,423</u>
<b>Total Funds</b>	<b><u>\$22,988,423</u></b>	<b><u>\$11,872,160</u></b>	<b><u>\$42,259,776</u></b>	<b><u>\$77,120,359</u></b>

**Changes in Endowment Net Assets for the Fiscal Year Ended May 31, 2012**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$23,300,784	\$18,421,325	\$41,945,324	\$83,667,433
Investment return:				
Investment income	326,553	338,140	-	664,693
Net appreciation (realized and unrealized)	<u>(495,217)</u>	<u>(4,884,417)</u>	<u>10,959</u>	<u>(5,368,675)</u>
Total investment return	<u>(168,664)</u>	<u>(4,546,277)</u>	<u>10,959</u>	<u>(4,703,982)</u>
Rental income	727,684	-	-	727,684
BSI revenue	3,038,595	-	-	3,038,595
Contributions	-	12,000	227,931	239,931
Appropriation of endowment assets for expenditure	<u>(1,563,786)</u>	<u>(2,068,838)</u>	<u>-</u>	<u>(3,632,624)</u>
Other changes:				
BSI expenses	<u>(2,163,036)</u>	<u>-</u>	<u>-</u>	<u>(2,163,036)</u>
Interest expense	<u>(260,487)</u>	<u>-</u>	<u>-</u>	<u>(260,487)</u>
Miscellaneous income/(expense)	<u>(59,299)</u>	<u>(78,620)</u>	<u>75,562</u>	<u>(62,357)</u>
Intercompany adjustment	<u>136,632</u>	<u>132,570</u>	<u>-</u>	<u>269,202</u>
<b>Endowment net assets, end of year</b>	<b><u>\$22,988,423</u></b>	<b><u>\$11,872,160</u></b>	<b><u>\$42,259,776</u></b>	<b><u>\$77,120,359</u></b>

**Houston Baptist University and Subsidiary**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**NOTE O - ENDOWMENTS - Continued**

**2011**

**Endowment Net Asset Composition by Type of Fund as of May 31, 2011**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$ 18,421,325	\$41,945,324	\$60,366,649
Board-designated endowment Funds	<u>23,300,784</u>	<u>-</u>	<u>-</u>	<u>23,300,784</u>
<b>Total Funds</b>	<b><u>\$23,300,784</u></b>	<b><u>\$18,421,325</u></b>	<b><u>\$41,945,324</u></b>	<b><u>\$83,667,433</u></b>

**Changes in Endowment Net Assets for the Fiscal Year Ended May 31, 2011**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$23,750,160	\$12,139,350	\$40,881,149	\$76,770,659
Investment return:				
Investment income	252,385	391,384	-	643,769
Net appreciation (realized and unrealized)	<u>(147,004)</u>	<u>8,172,282</u>	<u>50,136</u>	<u>8,075,414</u>
Total investment return	105,381	8,563,666	50,136	8,719,183
Rental income	685,840	-	-	685,840
BSI revenue	3,244,454	-	-	3,244,454
Contributions	-	6,000	470,813	476,813
Appropriation of endowment assets for expenditure	(1,999,088)	(2,285,365)	85,285	(4,199,168)
Other changes:				
BSI expenses	(2,114,093)	-	-	(2,114,093)
Interest expense	(359,981)	-	-	(359,981)
Miscellaneous income/(expense)	(11,891)	(2,325)	-	(14,214)
Intercompany adjustment	<u>-</u>	<u>-</u>	<u>457,941</u>	<u>457,941</u>
<b>Endowment net assets, end of year</b>	<b><u>\$23,300,784</u></b>	<b><u>\$18,421,325</u></b>	<b><u>\$41,945,324</u></b>	<b><u>\$83,667,433</u></b>

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE O - ENDOWMENTS - Continued

#### Description of Amounts Classified as Permanently Restricted Net Assets and Temporarily Restricted Net Assets (Endowment Only)

	May 31, 2012	May 31, 2011
<b>Temporarily Restricted Net Assets</b>		
The portion of perpetual endowment funds subject to a time restriction under UPMIFA:		
Without purpose restrictions	\$ 1,872,651	\$ 3,007,836
With purpose restrictions	9,999,509	15,413,490
<b>Total endowment funds classified as temporarily restricted net assets</b>	<b>\$11,872,160</b>	<b>\$18,421,325</b>
<b>Permanently Restricted Net Assets</b>		
The portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or by UPMIFA		
<b>Total endowment funds classified as permanently restricted net assets</b>	<b>\$42,259,776</b>	<b>\$41,945,324</b>

#### 1. Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires the University to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature are \$285,004 and \$152,435 as of May 31, 2012 and May 31, 2011, respectively and are included in satisfaction of program restrictions on the Consolidated Statement of Activities. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new permanently restricted contributions and continued appropriation for certain programs was deemed prudent by the Board of Trustees of the University.

#### 2. Return Objectives and Risk Parameters

The University has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the real purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the University must hold in perpetuity or for a donor-specified period(s) as well as board-designated funds. Under this policy, as approved by the Board of Trustees, the endowment assets are invested in a manner that is intended to produce results that earn an average rate of return at least equal to the nominal spending rate policy plus the rate of inflation plus an additional return of 1%, net of all fees, including management advisory fees and custody charges, over the long term (defined as rolling 5 year periods).

# Houston Baptist University and Subsidiary

## SUPPLEMENTAL SCHEDULES CONSOLIDATING BALANCE SHEETS BEECHNUT STREET, INC. AND SUBSIDIARIES May 31, 2012

	Beechnut Street, Inc.						
	BSI	Fondren I	Fondren II	HBHC	HBHP I	Eliminations	Consolidated
<b>Assets</b>							
Cash and cash equivalents	\$ 25,454	\$ 37,670	\$ 21,559	\$ -	\$ 465,431	\$ -	\$ 550,114
Accounts receivables	-	-	574	-	-	-	574
Prepays and other assets	-	8,580	-	-	849	-	9,429
Investment in subsidiary	707,827	-	-	-	-	(707,827)	-
Investments in real estate	1,447,636	-	-	-	-	-	1,447,636
Plant, property, and equipment, net accumulated depreciation of \$3,567,446 in 2012.	29,986	1,113,528	682,696	-	5,765,999	-	7,592,209
Receivable from University	-	-	-	-	428,181	-	428,181
Intercompany Receivable	-	-	2,437,977	-	988	(2,438,965)	-
<b>TOTAL ASSETS</b>	<b>\$ 2,210,903</b>	<b>\$ 1,159,778</b>	<b>\$ 3,142,806</b>	<b>\$ -</b>	<b>\$ 6,661,448</b>	<b>\$ (3,146,792)</b>	<b>\$ 10,028,143</b>
<b>Liabilities and Net Assets</b>							
Accounts payable and accrued expenses	\$ 13,867	\$ 105,361	\$ 45,506	\$ -	\$ 90,873	\$ -	\$ 255,607
Payable to University	1,677,514	1,104,524	200,658	979	-	-	2,983,675
Deferred revenues	1,275	8,848	28,869	-	-	-	38,992
Notes payable	-	411,082	1,757,004	-	5,719,115	-	7,887,201
Intercompany payable	2,288,852	150,113	-	-	-	(2,438,965)	-
<b>Total liabilities</b>	<b>3,981,508</b>	<b>1,779,928</b>	<b>2,032,037</b>	<b>979</b>	<b>5,809,988</b>	<b>(2,438,965)</b>	<b>11,165,475</b>
Shareholders' equity (deficit)	(1,770,605)	(620,150)	1,110,769	(979)	851,460	(707,827)	(1,137,332)
<b>Total liabilities and shareholders' equity (deficit)</b>	<b>\$ 2,210,903</b>	<b>\$ 1,159,778</b>	<b>\$ 3,142,806</b>	<b>\$ -</b>	<b>\$ 6,661,448</b>	<b>\$ (3,146,792)</b>	<b>\$ 10,028,143</b>

See Report of Independent Certified Public Accountants

# Houston Baptist University and Subsidiary

## SUPPLEMENTAL SCHEDULES CONSOLIDATING STATEMENTS OF INCOME BEECHNUT STREET, INC. AND SUBSIDIARIES Fiscal Year Ended May 31, 2012

	Beechnut Street, Inc.					HBHP I	Eliminations	Consolidated
	BSI	Fondren I	Fondren II	HBHC				
Operating Revenues and Support								
Rental revenue	\$ 100,803	\$ 953,289	\$ 478,163	\$ -	\$ 1,496,288	\$ -	\$ -	\$ 3,028,543
Investment income	-	-	-	-	549	-	-	549
Other	-	408	250	-	9,394	-	-	10,052
Total operating revenues and support	100,803	953,697	478,413	-	1,506,231	-	-	3,039,144
Operating expenses:								
Selling, general, and administrative								
Plant	348,860	46,950	24,789	-	296,928	-	-	717,527
Depreciation expense	39,559	224,405	65,270	-	509,654	-	-	838,888
Taxes	1,842	25,849	40,958	-	241,117	-	-	309,766
Other	26,610	194,726	62,373	-	13,124	-	-	296,833
	-	-	-	-	22	-	-	22
Total operating expenses	416,871	491,930	193,390	-	1,060,845	-	-	2,163,036
Operating income (loss)	(316,068)	461,767	285,023	-	445,386	-	-	876,108
Non-operating expenses:								
Interest expense	(5)	(15,579)	(27,954)	-	(216,954)	-	-	(260,492)
Casualty loss	-	-	-	-	-	-	-	-
Lease Expense (Paid To HBU)	-	(816,000)	(117,700)	-	(61,240)	-	-	(994,940)
Other intercompany income	-	-	-	-	-	-	-	-
Total non-operating expenses	(5)	(831,579)	(145,654)	-	(278,194)	-	-	(1,255,432)
Net income (loss)	(316,073)	(369,812)	139,369	-	167,192	-	-	(379,324)
Beginning equity (deficit)	(1,454,532)	(250,338)	971,400	(979)	684,268	(707,827)		(758,008)
Ending equity (deficit)	\$ (1,770,605)	\$ (620,150)	\$ 1,110,769	\$ (979)	\$ 851,460	\$ (707,827)	\$	\$ (1,137,332)

See Report of Independent Certified Public Accountants

Consolidated Financial Statements and Independent Auditor's Report  
**Houston Baptist University and Subsidiary**

May 31, 2013 and 2012

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## Independent Auditor's Report

Board of Trustees  
Houston Baptist University

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements Houston Baptist University and its subsidiary (collectively, the "University"), which comprise the consolidated statements of financial position as of May 31, 2013 and 2012, and the related consolidated statements of activities, and cash flows for the years then ended, and the related notes to the financial statements.

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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## **Independent Auditor's Report**

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### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Houston Baptist University and its subsidiary as of May 31, 2013 and 2012, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

### ***Other Matter - Supplementary Information***

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying supplemental consolidating balance sheets and consolidating statements of income of Beechnut Street, Inc. and subsidiaries is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

### **Other Reporting Required by Government Auditing Standards**

In accordance with Government Auditing Standards, we have also issued our report dated September 13, 2013 on our consideration of Houston Baptist University and subsidiary's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards in considering Houston Baptist University and subsidiary's internal control over financial reporting and compliance.

*Fitz, Roberts & Co., P.C.*

Houston, Texas  
September 13, 2013

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**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**  
May 31, 2013 and 2012

	2013	2012
<b>Assets</b>		
Cash and cash equivalents	\$ 12,492,880	\$ 6,046,857
Receivables, principally from students, net of allowance for doubtful accounts of \$2,484,214 and \$2,584,258 in 2013 and 2012, respectively	3,182,712	3,392,560
Pledges receivable, net	3,420,237	573,383
Prepayments, inventories and other assets	1,388,618	1,401,986
Investments	77,722,263	69,558,049
Escrow funds	243,210	1,816,765
Investment in plant assets, net	120,326,608	118,605,342
Interests in perpetual trusts held by others	4,122,668	3,570,219
Interests in trusts administered by others	3,003	61,805
Cash, restricted	2,964,209	4,853,755
<b>TOTAL ASSETS</b>	<b>\$ 225,866,408</b>	<b>\$ 209,880,721</b>
<b>Liabilities and Net Assets</b>		
Accounts payable and accrued liabilities	\$ 7,368,344	\$ 6,270,704
Deferred income	409,454	358,723
Deposits and agency funds	1,120,113	899,387
Interest rate swap	5,464,209	7,506,056
Notes payable	20,772,900	20,125,024
Bonds payable	49,145,000	50,180,000
<b>TOTAL LIABILITIES</b>	<b>84,280,020</b>	<b>85,339,894</b>
Net Assets:		
Unrestricted	72,842,093	68,430,791
Temporarily restricted	24,561,993	13,850,260
Permanently restricted	44,182,302	42,259,776
<b>TOTAL NET ASSETS</b>	<b>141,586,388</b>	<b>124,540,827</b>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b>\$ 225,866,408</b>	<b>\$ 209,880,721</b>

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF ACTIVITIES**  
Fiscal Years ended May 31, 2013 and 2012

	Unrestricted		Temporarily Restricted		Permanently Restricted		Total	
	2013	2012	2013	2012	2013	2012	2013	2012
Operating revenues and support								
Tuition and fees								
Funded	\$ 58,871,822	\$ 54,877,299	\$ -	\$ -	\$ -	\$ -	\$ 58,871,822	\$ 54,877,299
Unfunded	(5,100,103)	(5,375,871)	-	-	-	-	(5,100,103)	(5,375,871)
	(22,460,464)	(21,277,250)	-	-	-	-	(22,460,464)	(21,277,250)
Tuition and fees, net	31,311,255	28,224,178	-	-	-	-	31,311,255	28,224,178
Private gifts and grants:								
Baptist General Convention of Texas	659,705	513,440	-	-	-	-	659,705	513,440
Government grants & contracts	2,941,071	3,121,195	217,705	157,548	-	-	3,158,776	3,278,743
Gifts in kind	121,031	302,606	-	-	-	-	121,031	302,606
Other	6,251,141	681,444	6,928,566	1,789,622	-	-	13,179,707	2,471,066
Investment and endowment income	1,239,189	1,291,492	473,608	402,045	-	-	1,712,797	1,693,537
Sales and services of auxiliary enterprises	6,199,505	5,486,598	9,195	7,300	-	-	6,208,700	5,493,898
Other	114,912	189,638	-	-	-	-	114,912	189,638
BSI revenue	2,940,629	3,038,595	-	-	-	-	2,940,629	3,038,595
Net assets released from restriction:								
Satisfaction of program restrictions	3,340,045	4,494,572	(3,340,045)	(4,570,134)	-	75,562	-	-
Total operating revenues and support	55,118,483	47,343,758	4,289,029	(2,213,619)	-	75,562	59,407,512	45,205,701
Operating Expenses:								
Educational and general:								
Instructional	17,216,430	15,956,070	-	-	-	-	17,216,430	15,956,070
Academic support	3,424,330	3,383,925	-	-	-	-	3,424,330	3,383,925
Student services	4,268,355	3,910,869	-	-	-	-	4,268,355	3,910,869
Institutional support	11,726,416	10,593,878	-	-	-	-	11,726,416	10,593,878
Total education and general	36,635,531	33,844,742	-	-	-	-	36,635,531	33,844,742
Auxiliary enterprises	13,279,753	11,142,141	-	-	-	-	13,279,753	11,142,141
BSI expenses (excluding interest)	2,079,212	2,163,036	-	-	-	-	2,079,212	2,163,036
Total operating expenses	51,994,496	47,149,919	-	-	-	-	51,994,496	47,149,919

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF ACTIVITIES - CONTINUED**  
Fiscal Years ended May 31, 2013 and 2012

	Unrestricted		Temporarily Restricted		Permanently Restricted		Total	
	2013	2012	2013	2012	2013	2012	2013	2012
EXCESS (DEFICIT) OF OPERATING REVENUES OVER (UNDER) OPERATING EXPENSES	\$ 3,123,987	\$ 193,839	\$ 4,289,029	\$ (2,213,619)	\$ -	\$ 75,562	\$ 7,413,016	\$ (1,944,218)
Non-operating activities:								
Contributions	-	-	-	-	1,820,678	227,931	1,820,678	227,931
Net assets released from restrictions:								
Satisfaction of capital acquisition restrictions	506,788	2,108,102	(506,788)	(2,108,102)	-	-	-	-
Interest on indebtedness	(2,106,329)	(1,849,656)	-	-	-	-	(2,106,329)	(1,849,656)
Change in value of split interest agreements	-	-	391,799	(321,887)	101,848	10,959	493,647	(310,928)
Unrealized gain/(loss) on investments	2,879,801	(5,471,747)	3,579,902	(5,685,080)	-	-	6,459,703	(11,156,827)
Realized gain/(loss) on sale of investments	7,055	829,193	2,957,791	1,255,120	-	-	2,964,846	2,084,313
Total from non-operating activities	1,287,315	(4,384,108)	6,422,704	(6,859,949)	1,922,526	238,890	9,632,545	(11,005,167)
Change in net assets	4,411,302	(4,190,269)	10,711,733	(9,073,568)	1,922,526	314,452	17,045,561	(12,949,385)
Net assets - beginning of year	68,430,791	72,621,060	13,850,260	22,923,828	42,259,776	41,945,324	124,540,827	137,490,212
Net assets - end of year	\$ 72,842,093	\$ 68,430,791	\$ 24,561,993	\$ 13,850,260	\$ 44,182,302	\$ 42,259,776	\$ 141,586,388	\$ 124,540,827

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
Fiscal Years ended May 31, 2013 and 2012

	2013	2012
Cash flows from operating activities:		
Change in net assets	\$ 17,045,561	\$ (12,949,385)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Realized (gain) on sale of investments	(2,964,846)	(2,084,313)
Unrealized (gain)/loss on investments	(4,417,856)	7,101,659
(Gain) / Loss from bond interest swap	(2,041,847)	4,055,168
Gifts of long lived assets and securities	(3,438,660)	-
Change in value of split-interest agreements and other trusts	(493,647)	310,928
Reinvested interest and dividends	(595,920)	(546,909)
Bad debt expense	911,555	1,171,307
Depreciation and amortization on investment in plant assets	4,951,119	4,323,625
Proceeds from contributions restricted for long-term investment	(1,820,678)	(227,931)
Changes in:		
Receivables, net	(701,707)	(666,106)
Pledges receivable, net	(2,846,854)	887,904
Prepayments, inventories, and other assets	13,368	16,639
Accounts payable and accrued liabilities	1,139,335	(122,274)
Deposits and agency funds	220,726	124,494
Deferred income	50,731	91,940
Net cash provided by operating activities	5,010,380	1,486,746
Cash flows from investing activities:		
Purchases of investments	(13,237,128)	(13,519,597)
Proceeds from sale of investments	16,490,195	15,122,483
Purchases of plant assets	(6,672,385)	(16,571,575)
Contractual payments on annuities	(41,695)	(41,545)
Net cash (used in) investing activities	(3,461,013)	(15,010,234)
Cash flows from financing activities:		
Proceeds from contributions restricted for long-term investment	1,820,679	227,931
Cash, restricted	3,463,101	(5,750,520)
Payments on bonds	(1,035,000)	(980,000)
Proceeds from notes payable	3,020,421	12,076,530
Payments on notes payable	(2,372,545)	(574,684)
Net cash provided by financing activities	4,896,656	4,999,257
Net increase (decrease) in cash and cash equivalents	6,446,023	(8,524,231)
Cash and cash equivalents at beginning of year	6,046,857	14,571,088
Cash and cash equivalents at end of year	\$ 12,492,880	\$ 6,046,857
Noncash transactions		
Retirement of plant assets	\$ 54,711	\$ 199,652

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

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### **1. General**

Houston Baptist University (the "University") is a private, non-profit institution of higher education based in Houston, Texas. The University is affiliated with the Baptist General Convention of Texas and provides education and training services primarily for students at the undergraduate and graduate levels. The University is a non-profit organization exempt from Federal income taxes under 501(a) as an organization described in Section 501(c)(3) of the Internal Revenue Code. The University is primarily supported by tuition and fees from students.

Beechnut Street, Inc. ("BSI") is a wholly-owned for-profit subsidiary of the University's Quasi Endowment Fund. BSI was established to hold and operate certain real estate and other investments. It owns a 21,953 square foot retail center and two adjoining ground leases situated on approximately 6.7 acres located on the northeast perimeter of the campus, known as Fondren II. In November 2007, BSI purchased Fondren I which consists of two in-line strip retail buildings containing 173,355 square feet, a freestanding retail store containing 9,000 square feet and one pad site improved with approximately 3,200 square feet of restaurant located on 15.2802 acres of land on the southeast corner of Fondren and US 59.

HB Housing Partnership I, LTD. (the "Partnership" or "HBHPI") is a Texas Limited Partnership that operates the student housing apartment complex known as Husky Village. The Partnership commenced operations in March 1997 with two limited partners, HB Housing Corp ("HBHC"), a Texas Corporation, and BSI. The Partnership entered into an amended ground lease dated February 2003, with Houston Baptist University and constructed a 143 unit apartment complex in three phases, designed and financed by the Partnership, that houses students attending Houston Baptist University. During the year ended August 2004, BSI purchased the ownership interest of HBHC and the Partnership, along with HBHC, and became wholly-owned by BSI.

The balance sheet and statement of income of the Partnership, HBHC, and BSI prior to consolidation with the University are included in the supplemental schedules to this report.

Bradshaw Recreation Center, Inc. ("BRC"), a non-profit organization under Section 501(c)(3) of the Internal Revenue Code, was formed in December 2011 to manage the operations of the Bradshaw Fitness Center. BRC is a wholly owned subsidiary of Houston Baptist University and is in the process of applying for tax exemption at the state and federal levels.



## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -- Continued

##### **2. Basis of Presentation**

The consolidated financial statements include the accounts of the various academic and administrative divisions of the University, the Partnership and BSI. Inter-company balances and transactions are eliminated upon consolidation.

Revenues, expenses, gains and losses are recorded on the accrual basis of accounting and are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the University are classified and reported as follows:

Permanently restricted - Net assets subject to donor-imposed stipulations that they be maintained permanently by the University. Generally, the donors of these assets permit the University to use all or part of the income earned on related investments for general or specific purposes. The income is included in temporarily restricted or unrestricted net assets as applicable.

Temporarily restricted - Net assets subject to donor-imposed stipulations that may or will be met either by actions of the University and/or the passage of time.

Unrestricted - Net assets that are not subject to donor-imposed stipulations.

Revenues from sources other than contributions are reported as increases in unrestricted net assets. Expenses are reported as decreases in unrestricted net assets. Gains or losses on investments are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulations or by law. Expirations of temporary restrictions recognized on net assets (e.g., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications from temporarily restricted net assets to unrestricted net assets. Temporary restrictions on gifts to acquire long-lived assets are considered met in the period in which the assets are acquired or placed in service.

Contributions, including unconditional promises to give, are recognized as revenues in the period received. Contributions of assets other than cash are recorded at their estimated fair value at the date of gift. Contributions to be received after one year are discounted at the three year treasury note rate. Amortization of the discount is recorded as additional contribution revenue in accordance with donor-imposed restrictions, if any, on the contributions. An allowance is made for uncollectible contributions based upon management's judgment and analysis of the creditworthiness of the donors, past collection experience and other relevant factors.

##### **3. Cash and Cash Equivalents**

Cash equivalents include time deposits, certificates of deposit, and highly liquid debt instruments with maturities of three months or less at date of acquisition.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

##### **4. Escrow Funds**

Escrow funds represent proceeds received from the note payable with a bank designated for the purchase and installation of equipment to be installed in various campus buildings and facilities.

##### **5. Accounts Receivable and Related Allowance for Doubtful Accounts**

Accounts receivable relate primarily to receivables from students. Tuition and registration charges relating to future semesters are recorded as deferred revenue when collected. Uncollected future fees are not recorded until the semester begins.

The estimated allowances for uncollectible accounts and notes receivable are accounted for using the reserve method. Under this method, allowances are maintained at a level which, in the judgment of management, is adequate to meet the present and potential risks of uncollectibility of the accounts and notes receivable. Management's judgment is based on a variety of factors, which include experience related to charge-offs and recoveries, and scrutiny of individual accounts and notes receivable. Amounts deemed by management to be uncollectible are charged to expense. Recoveries on receivables previously charged-off are credited to expense. Provisions for receivable losses are charged to expense and credited to the allowance for doubtful accounts.

##### **6. Inventories**

Inventories, which consist primarily of textbooks, clothing, gifts and supplies are stated at cost and are expensed using the first in, first out method.

##### **7. Investments**

Investments in corporate stocks and bonds are stated at quoted market value. Oil and gas royalty interests are valued by an independent appraiser. Other investments consist of a long-term certificate of deposit which is carried at cost. Real estate is stated at fair market value as determined by independent appraisers. All real estate investments are held primarily for campus expansion and to function as sources of Quasi Endowment Fund income for the University. Real estate investment income is recognized net of related direct expenses. Investments in private investment funds are carried at net asset value as a practical expedient for determining fair values. The University may redeem its investments in private funds annually with 95 days notice.

Unrealized gains and losses resulting from increases and decreases in such fair market values are recognized during the period in which the change occurs.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued**

Pooled endowment and similar funds are invested on the basis of a total return policy to provide income and to realize appreciation in investment values. Amounts distributed from endowment funds to support operations for general or specific purposes are based on the trailing twelve quarter average market value of the investment pool.

#### **8. Restricted Cash**

Under a swap agreement between the University and a bank, the University is required to maintain a specified cash balance with the bank as collateral, if the swap liability exceeds a certain threshold. As of May 31, 2013 and 2012, the required balance was \$2,964,209 and \$4,853,755, respectively.

#### **9. Concentration of Credit Risk**

The University places its cash and cash equivalents with well capitalized financial institutions, which at times may exceed federally insured limits. The University has not experienced any losses of such accounts.

#### **10. Investment in Plant Assets**

Investment in plant assets are stated at cost less accumulated depreciation and amortization. Cost is determined by the purchase price or fair value, if acquired by gift. Campus land, construction in progress, and art and historical objects are not subject to depreciation or amortization. The University capitalizes items in excess of \$2,500 with a useful life of at least three years. Leasehold improvements are amortized over the shorter of the lease term or useful life of the asset. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets.

#### **11. Perpetual Trusts**

The University is the beneficiary of certain perpetual trusts held and administered by others, specifically the Baptist Foundation of Texas. The present values of the estimated future cash receipts from the trusts are recognized as assets and contribution revenues at the dates the trusts are established. Distributions of income from the trusts are recorded as contributions and the carrying value of the assets are adjusted for changes in the estimates of future receipts.

#### **12. Derivative Instruments and Hedging Activities**

The University follows FASB Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*, which establishes accounting and reporting standards for derivative instruments. Specifically, the standard requires all entities, including not-for-profit organizations, to recognize all derivatives as either assets or liabilities in their statement of financial position and to measure such instruments at fair value. Changes in the fair value of derivative financial instruments are recognized periodically as changes in net assets.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

##### **13. Functional Expenses**

Costs related to the operation and maintenance of physical plant, including depreciation and amortization of plant assets, are allocated to program and supporting activities based upon the percentage of total assets utilized by the applicable program or activity (see Note G).

##### **14. Advertising Costs**

Advertising costs are expensed as incurred. Advertising costs were approximately \$1,218,000 and \$598,000 for 2013 and 2012, respectively, and were charged to operating expenses.

##### **15. Operating Revenues and Support and Non-operating Activities**

Revenues and expenses included in operating revenues and support relate primarily to the University's educational mission. Non-operating activities include contributions to endowments, interest on indebtedness, and gains and losses on valuation and sales of assets.

##### **16. 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 judgments that affect the reported amounts of assets and liabilities and disclosures of contingencies at the date of the financial statements and revenues and expenses recognized during the reporting period. Significant estimates made by management include the estimated fair value of investments other than marketable securities (primarily real estate), the allowance for doubtful accounts, discounts on pledge receivables, the fair value of investments in perpetual trusts held by others, the estimated payable for life annuitants, and the fair value of the interest rate swap. Actual results could differ from those estimates.

##### **17. Fair Value Option**

FASB ASC 825 *Financial Instruments* permits entities to choose to measure certain financial instruments and other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. As permitted by the standard, management elects not to elect the fair value option, for the financial assets and liabilities that had not been previously carried at fair value.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES –  
Continued**

**18. Income Taxes**

The University follows ASC 740 which requires the evaluation of how tax positions should be recognized, measured, presented, and disclosed in the financial statements. The standard requires the evaluation of tax positions taken or expected to be taken in the course of preparing tax returns to determine whether the tax positions are “more-likely-than-not” of being sustained by the applicable taxing authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. The adoption of ASC 740 did not have an effect on the University’s net asset value, financial position or results of activities. As of May 31, 2013 and 2012 and for the years then ended, the University and its subsidiary, BSI, did not have an asset or liability for any unrecognized tax positions. Management’s determinations regarding ASC 740 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an on-going analysis of tax laws, regulations and interpretations thereof.

**19. Recently Issued Accounting Standards**

Recent accounting pronouncements issued by the Financial Accounting Standards Board did not or are not believed by management to have a material impact on the University’s present or future financial statements.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE B - ALLOWANCE FOR DOUBTFUL ACCOUNTS**

An allowance for doubtful accounts is provided against student receivables as discussed in Note A. The allowance for doubtful accounts at May 31, consists of the following:

	<u>2013</u>	<u>2012</u>
Allowance for doubtful accounts - beginning of year	\$ 2,584,258	\$ 2,282,891
Add: provision for doubtful accounts	911,555	1,171,307
Less: accounts written off	<u>(1,011,599)</u>	<u>(869,940)</u>
 Allowance for doubtful accounts - end of year	 <u>\$ 2,484,214</u>	 <u>\$ 2,584,258</u>

The provision for doubtful accounts is included in institutional support on the consolidated statements of activities.

**NOTE C - PLEDGES RECEIVABLE, NET**

Pledges receivable, net, at May 31, consists of the following:

	<u>2013</u>	<u>2012</u>
Unconditional promise expected to be collected in:		
Less than one year	\$ 770,836	\$ 438,606
One year to five years	2,210,838	136,067
Greater than five years	<u>450,000</u>	<u>-</u>
	3,431,674	574,673
Less unamortized discount	<u>(11,437)</u>	<u>(1,290)</u>
 Total pledges receivable, net	 <u>\$ 3,420,237</u>	 <u>\$ 573,383</u>

Pledges receivable were discounted using rates ranging from .35% to .79%.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE D - INVESTMENTS

Investments at fair value, at May 31, consist of the following:

	2013	2012
Common stocks	\$ 22,092	\$ 1,117,631
Bonds	2,125,519	11,113,924
Mutual funds	39,057,064	25,194,784
Private investment fund	6,464,882	5,801,869
Real estate	27,887,705	24,731,432
Oil and gas royalty interests	2,100,001	1,533,409
Other investments	65,000	65,000
Total	<u>\$ 77,722,263</u>	<u>\$ 69,558,049</u>

The University nets investment fees against investment and endowment income. Investment fees were approximately \$202,000 and \$220,000 for the years ended May 31, 2013 and 2012, respectively.

#### NOTE E - RISKS AND UNCERTAINTIES

The University invests in various investment securities. Investment securities are exposed to various risks, such as interest rate, overall market volatility and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the University's account balances and the amounts reported in the statements of financial position.

#### NOTE F - SALE OF REAL ESTATE

In 2005, the University sold the right to use certain real estate assets held for investment (parcel 2) for approximately \$941,000. Under the terms of this agreement, the land and improvements will revert back to the University in the year 2020.

This transaction has been recorded as a sale of property since the University will not have a right to use this land for approximately 14 years. Because the land and improvements will revert to the University, the current fair value of the property is being accrued into the financial statements over the 14 year period prior to the reversion of the land and improvements. The cumulative amount accrued as an asset and income for parcel 2 for the years ended May 31, 2013 and 2012 was approximately \$597,000 and \$521,000, respectively.

**Houston Baptist University and Subsidiary**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**NOTE G - INVESTMENT IN PLANT ASSETS, NET**

Investment in plant assets, net, consists of the following at May 31:

	Estimated Useful Life	2013	2012
Buildings	20 - 50 years	\$ 110,861,817	\$ 107,618,115
Furniture, equipment, and library books	3 - 10 years	20,357,626	19,753,051
Land improvements	10 - 20 years	16,027,931	15,488,271
Software	10 years	2,388,388	2,317,188
Leasehold improvements	10 - 20 years	1,717,892	1,714,292
Vehicles	5 years	467,032	427,536
		151,820,686	147,318,453
Less accumulated depreciation and amortization		(47,367,190)	(42,470,783)
Campus land		6,360,248	6,360,248
Art and historical objects		6,048,511	5,908,305
Construction in progress		3,464,353	1,489,119
Total investment in plant assets		<u>\$ 120,326,608</u>	<u>\$ 118,605,342</u>

Depreciation and amortization expense for the years ended May 31, 2013 and 2012 was \$4,951,119 and \$4,323,625, respectively. Operation of plant expense for the years ended May 31, 2013 and 2012 was \$4,154,550 and \$4,794,527, respectively. Depreciation and amortization and operation of plant expense have been allocated to functional programs and supporting activities as follows:

	Depreciation and Amortization Expense		Operation of Plant Expense	
	2013	2012	2013	2012
Instructional	\$ 1,594,112	\$ 1,468,201	\$ 1,195,750	\$ 1,437,403
Academic support	337,555	310,828	253,201	304,314
Student services	277,278	223,434	207,986	221,980
Institutional support	554,555	510,819	415,974	500,097
Auxiliary enterprises	1,873,244	1,500,578	1,405,128	1,491,845
BSI	314,375	309,765	676,511	838,888
	<u>\$ 4,951,119</u>	<u>\$ 4,323,625</u>	<u>\$ 4,154,550</u>	<u>\$ 4,794,527</u>



**Houston Baptist University and Subsidiary**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**NOTE H - DEBT**

	<u>May 31, 2013</u>	<u>May 31, 2012</u>
<b><u>Bonds</u></b>		
Crawford Education Facilities Corporation ("CEFC") bonds, issued November 2007 in the amount of \$53,000,000 due in annual installments ranging from \$900,000 to \$3,220,000, beginning December 1, 2009 thru December 1, 2037. The interest rate is Securities Industry and Financial Markets Association ("SIFMA") plus 0.825%. On November 1, 2010, the bonds were remarketed publicly backed by a letter of credit from a bank. Under this agreement, the interest rate is SIFMA. At May 31, 2013, the interest rate was .18%. The bonds are secured by 6.686 acres of land, including improvements, and the future revenues of the University.	<u>\$49,145,000</u>	<u>\$50,180,000</u>
<b><u>Notes Payable</u></b>		
A note payable with a bank dated November 20, 2011 of \$5,839,182, requiring monthly principal and interest payments of \$35,880 with the balance due at the maturity on November 20, 2029. The note bears interest at 3.25% and is secured by a ground lease on 7.6660 acres and all tenant rents and leases.	5,473,539	5,719,115
A note payable with a bank dated August 28, 2012 of \$1,757,004. The note bears interest at the greater of the U.S. Prime Rate (as published by the Wall Street Journal) or 3.25%, and requires 84 monthly payments of principal and interest of \$23,452 beginning September 28, 2012 with all unpaid principal and accrued interest due at maturity on August 28, 2019. The note payable is secured by the 1st lien on Fondren II and all tenant rents and leases and is guaranteed by the University.	1,587,206	1,757,004
A note payable with a bank dated November 20, 2011 of \$419,718, requiring monthly payments of principal and interest of \$2,579, with the balance due at the maturity on November 20, 2029. The note payable bears interest at 3.25% and is secured by a ground lease on 7.6660 acres and all tenant rents and leases.	393,412	411,082

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE H - DEBT – Continued

A note payable with a non-profit organization dated January 1, 2012 of \$9,400,000, requiring 12 quarterly interest only payments through December 31, 2014. Quarterly principal and interest payments of \$143,138 begin March 31, 2015 through maturity at December 15, 2021, at which time any unpaid principal and accrued interest is due in full. The note bears interest at 4.5% and is secured by the Bradshaw Recreation Center (BRC).	9,400,000	9,400,000
A note payable with a bank dated March 2, 2012 of \$2,676,530, requiring 29 quarterly principal payments of \$55,762 plus interest with the balance due at the maturity on March 2, 2019. The note bears interest at 4.85% and is secured by 6.686 acres of land, all unrestricted gross revenues; all interest, dividends, cash, instruments and other property; escrow funds; and all other proceeds.	2,565,006	2,676,530
A note payable with a bank dated March 30, 2013 of \$6,000,000 total, of which \$1,263,417 has been funded as of May 31, 2013, requiring 12 quarterly payments, with the first 3 being interest only payments on the funded amount of the loan. 9 quarterly payments of \$666,667 are scheduled to begin June 30, 2014 with balance due on March 31, 2016. The note bears a variable interest rate of LIBOR plus 1.0% and is secured by various investments held in a trust account.	1,263,417	-
<b><u>Capital Leases</u></b>		
A capital lease arrangement with a leasing company dated August 14, 2009 of \$201,000, requiring 60 monthly payments of principal and interest of \$4,475 ending September 31, 2014.	58,016	101,470
A capital lease arrangement with a bank dated July 27, 2009 of \$129,792, requiring 60 monthly payments of principal and interest of \$2,599 ending July 31, 2014.	32,304	59,823
Total notes payable and capital leases	20,772,900	20,125,024
Total debt	<u>\$ 69,917,900</u>	<u>\$ 70,305,024</u>

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE H - DEBT – Continued

Future minimum payments under this debt are as follows:

May 31,	Bonds	Notes payable	Capital leases	Total
2014	\$ 1,080,000	\$ 731,208	\$ 84,887	\$ 1,896,095
2015	1,130,000	1,342,763	11,545	2,484,308
2016	1,180,000	1,482,726	-	2,662,726
2017	1,240,000	1,085,927	-	2,325,927
2018	1,295,000	969,842	-	2,264,842
Thereafter	43,220,000	15,070,114	-	58,290,114
Subtotal	49,145,000	20,682,580	96,432	69,924,012
Less amounts representing interest	-	-	(6,112)	(6,112)
Total	<u>\$ 49,145,000</u>	<u>\$ 20,682,580</u>	<u>\$ 90,320</u>	<u>\$ 69,917,900</u>

The interest expense on notes and bonds payable for the years ending May 31, 2013 and 2012, respectively, was approximately \$2,106,000 and \$1,850,000. The interest paid on notes and bonds payable for the years ending May 31, 2013 and 2012, respectively, was approximately \$2,121,000 and \$1,790,000.

The Master Bond Agreement contains a swap provision. Effective February 1, 2008, the University executed two interest rate swaps in the amounts of \$26,000,000 and \$12,000,000. The swaps bear interest at 3.8275% and 3.395% and mature December 1, 2027 and February 1, 2018, respectively. The University entered into the agreement to lock in fixed interest rates on the variable rate debt and is not using the agreements for speculative purposes. The amount recorded in net assets for the changes in value of the instrument was an unrealized gain of \$2,041,847 and unrealized loss of \$4,055,168, at May 31, 2013 and 2012, respectively, and is included as an unrealized gain (loss) on sale of investments in the consolidated statements of activities.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS**

The carrying amounts and estimated fair values of the University's financial instruments are as follows:

	<u>2013</u>		<u>2012</u>	
	<u>Carrying amount</u>	<u>Estimated fair value</u>	<u>Carrying amount</u>	<u>Estimated fair value</u>
Financial assets:				
Cash and cash equivalents	\$ 12,492,880	\$ 12,492,880	\$ 6,046,857	\$ 6,046,857
Receivables - principally from students, net	3,182,712	3,182,712	3,392,560	3,392,560
Pledges receivable, net	3,420,237	3,420,237	573,383	573,383
Investments:				
Common stocks	22,092	22,092	1,117,631	1,117,631
Bonds	2,125,518	2,125,518	11,113,924	11,113,924
Mutual funds	39,057,065	39,057,065	25,194,784	25,194,784
Private investment fund	6,464,882	6,464,882	5,801,869	5,801,869
Real estate	27,887,705	27,887,705	24,731,432	24,731,432
Oil and gas royalty interests	2,100,001	2,100,001	1,533,409	1,533,409
Certificate of deposit	65,000	65,000	65,000	65,000
Interests in perpetual trusts held by others	4,122,668	4,122,668	3,570,219	3,570,219
Interest in trusts administered by others	3,003	3,003	61,805	61,805
Financial liabilities:				
Accounts payable and accrued liabilities	7,368,344	7,368,344	6,270,704	6,270,704
Deposits and agency funds	1,120,113	1,120,113	899,387	899,387
Interest rate swap	5,464,209	5,464,209	7,506,056	7,506,056
Bonds payable	49,145,000	49,145,000	50,180,000	50,180,000
Notes payable	20,682,580	20,119,027	19,963,731	19,491,549
Capital leases payable	90,320	90,320	161,293	161,293

The methods and assumptions used to estimate the fair value of each class of financial instruments are as follows:

Cash and cash equivalents

The carrying amount approximates fair value due to the short maturity of those instruments.

Receivables- principally from students - net

The carrying amount approximates fair value based on the short maturities of accounts receivable.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued**

Pledges receivable - net

The fair value of pledges receivable is based on the discounted value of expected future cash flows.

Investments

Corporate stocks and bonds and real estate are carried at market value; therefore, the carrying value approximates fair value. Other investments consist of a long-term certificate of deposit carried at amortized cost which approximates fair value.

Interests in perpetual trusts held by others

The interests in trusts held by others are carried at fair value which is determined using the net asset value of shares held by the trusts.

Interests in trusts administered by others

The interests in trusts administered by others are carried at fair value which is determined using the net asset value of shares held by the trusts.

Accounts payable, accrued liabilities, deposits and agency funds

The carrying amount approximates fair value because of the short maturity of the financial instruments.

Bonds payable

The carrying value approximates fair value based on the variable interest rates of the bonds payable.

Interest rate swap

The interest rate swap is carried at fair value as determined by using current market rates.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

##### Notes payable

The estimated fair value of notes payable is based on discounting future cash flows using current interest rates at which similar loans could be obtained for the same remaining maturities.

The preceding methods described may produce a fair value calculation that may not be indicative of the net realizable value or reflective of future fair values. Furthermore, although the University believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The University follows the fair value guidance for its financial assets and liabilities. The guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability, in an orderly transaction between market participants at the measurement date. The guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The three levels of inputs that may be used to measure fair value:

- Level 1: Inputs based on quoted market prices for identical assets or liabilities in active markets at the measurement date.
- Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. The inputs are unobservable in the market and significant to the instruments valuation.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

The following table classifies the University's financial assets and liabilities measured at fair value on a recurring basis as of May 31, 2013:

Description	May 31, 2013	Level 1	Level 2	Level 3
<b>Financial assets:</b>				
Investments:				
Common stocks by sector:				
Basic material	\$ 22,092	\$ 22,092	\$ -	\$ -
Bonds:				
US Corporate	2,125,518	-	2,125,518	-
Mutual funds:				
Stocks	33,048,454	28,265,542	4,782,912	-
Bonds	6,008,611	2,342,160	3,666,451	-
Certificate of deposit	65,000	65,000	-	-
Private investment fund	6,464,882	-	6,464,882	-
Real estate	27,887,705	-	-	27,887,705
Oil and gas royalty interest	2,100,001	-	-	2,100,001
Interest in perpetual trusts held by others	4,122,668	-	4,122,668	-
Interests in trusts administered by others	3,003	-	3,003	-
Total financial assets at fair value	<u>\$ 81,847,934</u>	<u>\$ 30,694,794</u>	<u>\$ 21,165,434</u>	<u>\$ 29,987,706</u>
<b>Financial liabilities:</b>				
Interest rate swap	<u>\$ 5,464,209</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,464,209</u>

The University has made capital commitments to the investment manager of the alternative investment of \$5,434,000. As of May 31, 2013, all of this capital commitment has been funded.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued**

The following table classifies the University's financial assets and liabilities measured at fair value on a recurring basis as of May 31, 2012:

Description	May 31, 2012	Level 1	Level 2	Level 3
<b>Financial assets:</b>				
Investments:				
Common stocks by sector:				
Basic material	\$ 187,458	\$ 187,458	\$ -	\$ -
Financial	345,051	345,051	-	-
Services	402,691	402,691	-	-
Other	182,431	182,431	-	-
Bonds:				
US Government	5,879,732	5,879,732	-	-
US Corporate	3,122,122	-	3,122,122	-
Mutual funds:				
Stocks	25,194,784	11,729,306	13,465,478	-
Bonds	2,112,070	-	2,112,070	-
Certificate of deposit	65,000	65,000	-	-
Private investment fund	5,801,869	-	5,801,869	-
Real estate	24,731,432	-	-	24,731,432
Oil and gas royalty interest	1,533,409	-	-	1,533,409
Interest in perpetual trusts held by others	3,570,219	-	3,570,219	-
Interests in trusts administered by others	61,805	-	61,805	-
Total financial assets at fair value	<u>\$ 73,190,073</u>	<u>\$ 18,791,669</u>	<u>\$ 28,133,563</u>	<u>\$ 26,264,841</u>
<b>Financial liabilities:</b>				
Interest rate swap	<u>\$ 7,506,056</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 7,506,056</u>



**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued**

The schedule below reconciles the opening balance to the closing balance for the year ended May 31, 2013 for the items on the previous table which have been classified as Level 3:

	<u>Real estate</u>	<u>Oil and gas Royalty interests</u>	<u>Interest rate swap</u>
Balance, beginning of year	\$ 24,731,432	\$ 1,533,409	\$ (7,506,056)
Total gains (losses)			
Included in unrealized gain/(loss)			
on investments	156,273	566,592	2,041,847
Purchase/(Sales) of investments	3,000,000	-	-
Balance, end of year	<u>\$ 27,887,705</u>	<u>\$ 2,100,001</u>	<u>\$ (5,464,209)</u>

The schedule below summarizes the activity for the year ended May 31, 2012 for the items on the previous table which have been classified as Level 3:

	<u>Real estate</u>	<u>Oil and gas Royalty interests</u>	<u>Interest rate swap</u>
Balance, beginning of year	\$ 26,117,636	\$ 1,451,413	\$ (3,450,888)
Total gains (losses)			
Included in realized gain/(loss)			
on investments	(586,484)	-	-
Included in unrealized gain/(loss)			
on investments	(799,720)	81,996	(4,055,168)
Balance, end of year	<u>\$ 24,731,432</u>	<u>\$ 1,533,409</u>	<u>\$ (7,506,056)</u>

Total Level 3 gains or losses above are all included in the consolidated statements of activities, and all relate to financial assets and liabilities still held at year end.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE J - RETIREMENT PLAN AND TUITION REIMBURSEMENT**

In 1963, the University established a retirement plan for all regular full-time faculty members and administrative staff. In compliance with the Tax Reform Act of 1986, the plan (a defined contribution plan) was amended in January 1989. Employees who complete one year of service and who work a total of 1,000 hours during a calendar year are eligible to participate. Upon an employee reaching eligibility, contributions are made to the plan by the University in an amount equal to 5% of the participant's salary. In addition, at the discretion of the University, the University may elect to contribute an additional amount equal to the participant's contribution, but not to exceed 2.5% of the participant's salary. Effective June 1, 2009, this discretionary contribution has been temporarily discontinued by the University.

Employees may make voluntary contributions up to the limit allowed by law. Effective January 1, 1992, retirement benefits for new employees vest 100% after five years of employment. Participants in the plan prior to January 1, 1992 are fully vested from the time of initial contribution. Participants can elect to retire at various ages under the plan with the earliest being at age 55. Contributions to the Plan by the University were approximately \$861,000 and \$823,000 for 2013 and 2012, respectively.

Effective January 1, 2007 in an effort to encourage long-term continuous service, faculty and staff members who have completed ten continuous years of full-time employment at the University are eligible for tuition benefits for their children to attend other universities. An eligible faculty or staff member may receive up to 80% of the tuition remission amount that would have been received had the child attended the University. For the years ended May 31, 2013 and 2012 approximately \$20,000 and \$19,000 were expensed, respectively. After the fall term of 2009, this long-term tuition benefit was discontinued, though some grandfathered benefits are still being paid.

Also, faculty or staff members who have completed six months of continuous full-time employment at the University prior to the first day of the academic semester are eligible for tuition benefits for themselves as well as eligible spouses and children. For the years ended May 31, 2013 and 2012, respectively, approximately \$359,000 and \$453,000 were expensed for faculty, staff, and their spouses and children.

#### **NOTE K - TRUST FUNDS HELD BY OTHERS**

The University is the beneficiary of several trust funds administered primarily by the Baptist Foundation of Texas. No provision has been made for releasing trust principal to the University, except for the payment of specific capital improvements authorized under specified conditions of each trust. The amount of original trust principal has a fair value of approximately \$4,126,000 and \$3,632,000 on May 31, 2013 and 2012, respectively. Income distributions from these funds were approximately \$215,000 and \$260,000 in 2013 and 2012, respectively.

The University is the beneficiary of trust funds from various estates. Substantially all distributions from such trust funds are royalty income and totaled approximately \$189,000 and \$200,000 in 2013 and 2012, respectively, and are recorded in investment and endowment income.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE L - NET ASSETS**

Temporarily restricted net assets consist of the following at May 31:

	2013	2012
Pledges receivable principally for student, facilities and campus enhancements	\$ 2,172,037	\$ 516,813
Net cumulative income from endowment funds – (including unrealized gains) primarily for scholarships	15,252,582	10,440,822
Funds administered by others – life annuity funds	-	(13,757)
Trusts held by others	1,935,585	1,557,543
Student scholarships and loans	461,572	368,892
Equipment, renovations and operations	4,852,664	1,092,394
Life annuity funds	(112,447)	(112,447)
Total	<u>\$ 24,561,993</u>	<u>\$ 13,850,260</u>

Permanently restricted net assets and the purpose for which the income from those net assets is expendable are as follows:

	2013	2012
General endowment funds	\$ 35,951,055	\$ 34,003,720
Endowed academic scholarship funds	7,818,396	7,770,646
Life annuity funds	185,505	258,064
Student loan funds	227,346	227,346
Total	<u>\$ 44,182,302</u>	<u>\$ 42,259,776</u>

**NOTE M - DEVELOPMENT EXPENSES**

The University incurred expenses totaling approximately \$1,106,000 and \$1,068,000 for the years ended May 31, 2013 and 2012, respectively, related to development and fund-raising. Such amounts are included in institutional support expenses in the accompanying consolidated statements of activities.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE N - COMMITMENTS AND CONTINGENCIES

The University is the lessor of operating leases with third parties expiring in various years through 2022. Minimum future rental income under non-cancelable operating leases having remaining terms in excess of one year as of May 31 are:

	HBU	BSI	Total
2014	\$ 632,556	\$ 1,219,270	\$ 1,851,826
2015	445,170	610,761	1,055,931
2016	228,979	367,044	596,023
2017	234,312	195,969	430,281
2018	234,796	101,826	336,622
Thereafter	421,330	438,518	859,848
Total minimum future rental income	<u>\$ 2,197,143</u>	<u>\$ 2,933,388</u>	<u>\$ 5,130,531</u>

Rental income for the years ended May 31, 2013 and 2012 was approximately \$2,179,000 and \$2,232,000, respectively, and has been included in the investment and endowment income and BSI revenue on the consolidated statements of activities.

The University participates in various federal loan programs. In March 2010, Congress passed the Health Care and Education Reconciliation Act of 2010. Under this act, the federal government stopped giving subsidies to private banks to give out federally insured loans. Instead, loans are administered directly by the Department of Education. Subsequent to the passing of this Act, the Federal Direct Loan Program is the sole government-backed loan program in the United States, replacing the Federal Family Education Loan Program. The amount of loans disbursed under the Direct Loan Program for the years ended May 31, 2013 and 2012 was approximately \$17,883,000 and \$15,423,000, respectively. Amounts questioned as a result of audits, if any, could result in the University having to purchase the loan(s) from the lender as the loan(s) could have lost its (their) guaranteed status. Management believes that such amounts, if any, would be immaterial to the financial statements.

Activity of the Pell Grant program is not reflected in the consolidated statements of activities as the transactions are considered to be agency transactions. Students received approximately \$3,939,000 and \$3,799,000 from the Federal Pell Grant programs during fiscal years 2013 and 2012, respectively.

The University participates in various federal Title IV financial aid programs. The Department of Education requires private non-profit institutions to demonstrate financial responsibility by meeting certain ratio requirements. The University was in compliance with these requirements at May 31, 2013 and May 31, 2012.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE O - ENDOWMENTS

The University's endowment consists of approximately 365 individual funds established for a variety of purposes. Its endowment includes both donor-restricted endowment funds and funds designated by the Board of Trustees to function as endowments. As required by generally accepted accounting principles ("GAAP"), 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 Board of Trustees of the University has interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value 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 donated 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 in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization 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 donor-restricted 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 policy of the University.

**Houston Baptist University and Subsidiary**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

**NOTE O - ENDOWMENTS - Continued**

**2013**

**Endowment Net Asset Composition by Type of Fund as of May 31, 2013**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$17,118,385	\$44,182,302	\$61,300,687
Board-designated endowment Funds	24,166,686	-	-	24,166,686
<b>Total Funds</b>	<b>\$24,166,686</b>	<b>\$17,118,385</b>	<b>\$44,182,302</b>	<b>\$85,467,373</b>

**Changes in Endowment Net Assets for the Fiscal Year Ended May 31, 2013**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$22,988,423	\$11,872,160	\$42,259,776	\$77,120,359
Investment return:				
Investment income	298,725	416,069	-	714,794
Net appreciation (realized and unrealized)	711,024	7,086,115	101,848	7,898,987
Total investment return	1,009,749	7,502,184	101,848	8,613,781
Rental income	723,245	-	-	723,245
BSI revenue	2,940,629	-	-	2,940,629
Contributions	-	-	1,820,678	1,820,678
Appropriation of endowment assets for expenditure	(1,311,071)	(2,095,936)	-	(3,407,007)
Other changes:				
BSI expenses	(2,014,201)	-	-	(2,014,201)
Interest expense	(243,967)	(3,400)	-	(247,367)
Miscellaneous income/(expense)	(82,744)	-	-	(82,744)
Intercompany adjustment	156,623	(156,623)	-	-
<b>Endowment net assets, end of year</b>	<b>\$24,166,686</b>	<b>\$17,118,385</b>	<b>\$44,182,302</b>	<b>\$85,467,373</b>

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE O - ENDOWMENTS - Continued**

2012

**Endowment Net Asset Composition by Type of Fund as of May 31, 2012**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$ 11,872,160	\$42,259,776	\$54,131,936
Board-designated endowment Funds	22,988,423	-	-	22,988,423
<b>Total Funds</b>	<b>\$22,988,423</b>	<b>\$11,872,160</b>	<b>\$42,259,776</b>	<b>\$77,120,359</b>

**Changes in Endowment Net Assets for the Fiscal Year Ended May 31, 2012**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$23,300,784	\$18,421,325	\$41,945,324	\$83,667,433
Investment return:				
Investment income	326,553	338,140	-	664,693
Net appreciation (realized and unrealized)	(495,217)	(4,884,417)	10,959	(5,368,675)
Total investment return	(168,664)	(4,546,277)	10,959	(4,703,982)
Rental income	727,684	-	-	727,684
BSI revenue	3,038,595	-	-	3,038,595
Contributions	-	12,000	227,931	239,931
Appropriation of endowment assets for expenditure	(1,563,786)	(2,068,838)	-	(3,632,624)
Other changes:				
BSI expenses	(2,163,036)	-	-	(2,163,036)
Interest expense	(260,487)	-	-	(260,487)
Miscellaneous income/(expense)	(59,299)	(78,620)	75,562	(62,357)
Intercompany adjustment	136,632	132,570	-	269,202
<b>Endowment net assets, end of year</b>	<b>\$22,988,423</b>	<b>\$11,872,160</b>	<b>\$42,259,776</b>	<b>\$77,120,359</b>

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE O - ENDOWMENTS - Continued

#### Description of Amounts Classified as Permanently Restricted Net Assets and Temporarily Restricted Net Assets (Endowment Only)

	May 31, 2013	May 31, 2012
<b>Temporarily Restricted Net Assets</b>		
The portion of perpetual endowment funds subject to a time restriction under UPMIFA:		
Without purpose restrictions	\$ 2,848,658	\$ 1,872,651
With purpose restrictions	14,269,727	9,999,509
<b>Total endowment funds classified as temporarily restricted net assets</b>	<b>\$17,118,385</b>	<b>\$11,872,160</b>
<b>Permanently Restricted Net Assets</b>		
The portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or by UPMIFA		
	\$44,182,302	\$42,259,776
<b>Total endowment funds classified as permanently restricted net assets</b>	<b>\$44,182,302</b>	<b>\$42,259,776</b>

#### 1. Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires the University to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature are \$156,000 and \$285,004 as of May 31, 2013 and May 31, 2012, respectively and are included in satisfaction of program restrictions on the Consolidated Statement of Activities. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new permanently restricted contributions and continued appropriation for certain programs was deemed prudent by the Board of Trustees of the University.

#### 2. Return Objectives and Risk Parameters

The University has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the real purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the University must hold in perpetuity or for a donor-specified period(s) as well as board-designated funds. Under this policy, as approved by the Board of Trustees, the endowment assets are invested in a manner that is intended to produce results that earn an average rate of return at least equal to the nominal spending rate policy plus the rate of inflation plus an additional return of 1%, net of all fees, including management advisory fees and custody charges, over the long term (defined as rolling 5 year periods).



## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE O - ENDOWMENTS - Continued

##### 3. Strategies Employed for Achieving Objectives

To achieve its investment objective, the Fund's assets are considered to be divided into two major components: Drivers of Return and Risk Reducing assets. The Investment Committee will determine the classification of alternative or market neutral investments. The Fund's long-term commitment to these classes shall be:

	<u>Range</u>	<u>Long-term Target</u>
Drivers of return	55%-75%	65%
Risk reducing assets	25%-45%	35%

##### 4. Spending Policy and How the Investment Objectives Relate to Spending Policy

The University has a policy of appropriating for distribution each year 5 percent of its endowment fund's average fair value over the prior 12 quarters through the fiscal year ended preceding the fiscal year in which the distribution is planned. In establishing this policy, the University considered the long-term expected return on its endowment. Accordingly, over the long-term, the University expects the current spending policy to allow its endowment to grow. This is consistent with the University's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return.

#### NOTE P - RELATED PARTY TRANSACTIONS

During the year, the University made payments to various vendors who meet the requirements of a related party. The nature of these transactions is described below:

- A consultant firm was engaged to provide enrollment management strategy services to the University during the year ended May 31, 2007. The Chairman of the Board of the holding company which owns the firm, and who is also a principal owner of the firm, served as the Chairman of the Board of Trustees of the University until November 2012. The former board member became an owner in this firm subsequent to the initial contract between the University and the firm. In addition, the University's Vice President of Enrollment Services is a paid consultant for the firm. Total fees paid to this company were \$64,000 and \$67,000 for the years ended May 31, 2013 and 2012, respectively.
- A firm that provides property management services was engaged by the University's for-profit subsidiary, Beechnut Street, Inc. to manage its retail space in July 2010. The firm's Senior Vice President is the brother of the University's Vice President for Financial Operations. Total fees paid to this firm by the University were \$52,000 and \$44,000 for the years ended May 31, 2013 and 2012, respectively.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE P - RELATED PARTY TRANSACTIONS - Continued

BSI holds the ground lease for three properties that are owned by the University. They are the Fondren I Shopping Center, the Fondren II Shopping Center and the Husky Village Apartments. The amount of rental income for Fondren I paid by BSI to the University for the years ended May 31, 2013 and 2012, respectively, was approximately \$816,000 and \$816,000, which eliminates in consolidation. The amount of rental income for Fondren II paid by BSI to the University for the years ended May 31, 2013 and 2012, respectively, was approximately \$118,000 and \$118,000, which eliminates in consolidation. The amount of rental income for Husky Village paid by BSI to the University for the years ended May 31, 2013 and 2012, respectively, was approximately \$52,000 and \$61,000, which eliminates in consolidation.

#### NOTE Q - SACS CORE REQUIREMENT 2.11.1

The University is a member of the Southern Association of Colleges and Schools ("SACS"). As part of the reaffirmation process with SACS, the University must comply with core requirements, as outlined in *The Principles of Accreditation: Foundations for Quality Enhancement*. Core requirement 2.11.1 requires a separate financial schedule calculating unrestricted net assets, exclusive of plant assets and plant related debt, as follows:

	May 31, 2013	May 31, 2012
Unrestricted net assets	\$ 72,842,093	\$ 68,430,791
Less: Investment in campus plant	(113,008,704)	(111,013,132)
Add: Interest rate swap derivative related to campus plant debt	5,464,209	7,506,056
Add: Debt related to campus plant	62,463,743	59,741,293
Unrestricted net assets, exclusive of plant and plant related debt	<u>\$ 27,761,341</u>	<u>\$ 24,665,008</u>

#### NOTE R - LITIGATION

The University and its subsidiary are subject to legal actions arising in the ordinary course of business. Management does not believe that the outcome of any legal actions would have a material adverse affect on the consolidated financial position or changes in its net assets.

#### NOTE S - SUBSEQUENT EVENTS

The University is not aware of any subsequent events which would require recognition or disclosure in the consolidated financial statements. The University has evaluated all events that occurred between May 31, 2013 and September 13, 2013, the date the consolidated financial statements were available to be issued.

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## Supplementary Information

# Houston Baptist University and Subsidiary

## SUPPLEMENTAL SCHEDULES CONSOLIDATING BALANCE SHEETS BEECHNUT STREET, INC. AND SUBSIDIARIES May 31, 2013

	Beechnut Street, Inc.						
	BSI	Fondren I	Fondren II	HBHC	HBHP I	Eliminations	Consolidated
<b>Assets</b>							
Cash and cash equivalents	\$ 24,700	\$ 135,197	\$ 50,673	\$ -	\$ 1,079,659	\$ -	\$ 1,290,229
Accounts receivables	-	1,814	5,320	-	-	-	7,134
Prepays and other assets	-	8,580	-	-	-	-	8,580
Investment in subsidiary	707,827	-	-	-	-	(707,827)	-
Investments in real estate	1,447,636	-	-	-	-	-	1,447,636
Plant, property, and equipment, net accumulated depreciation of \$3,881,775 in 2013.	31,583	1,086,546	673,867	-	5,525,908	-	7,317,904
Receivable from University	-	-	-	-	8,660	-	8,660
Intercompany Receivable	-	-	2,385,570	-	10,605	(2,396,175)	-
<b>TOTAL ASSETS</b>	<b>\$ 2,211,746</b>	<b>\$ 1,232,137</b>	<b>\$ 3,115,430</b>	<b>\$ -</b>	<b>\$ 6,624,832</b>	<b>\$ (3,104,002)</b>	<b>\$ 10,080,143</b>
<b>Liabilities and Net Assets</b>							
Accounts payable and accrued expenses	\$ 17,587	\$ 104,143	\$ 38,178	\$ -	\$ 83,183	\$ -	\$ 243,091
Payable to University	2,204,412	1,341,229	229,556	979	-	-	3,776,176
Deferred revenues	-	17,008	30,359	-	-	-	47,367
Notes payable	-	393,412	1,587,206	-	5,473,539	-	7,454,157
Intercompany payable	2,081,818	314,357	-	-	-	(2,396,175)	-
Total liabilities	4,303,817	2,170,149	1,885,299	979	5,556,722	(2,396,175)	11,520,791
Shareholders' equity (deficit)	(2,092,071)	(938,012)	1,230,131	(979)	1,068,110	(707,827)	(1,440,648)
Total liabilities and shareholders' equity (deficit)	\$ 2,211,746	\$ 1,232,137	\$ 3,115,430	\$ -	\$ 6,624,832	\$ (3,104,002)	\$ 10,080,143

See independent auditor's report

# Houston Baptist University and Subsidiary

## SUPPLEMENTAL SCHEDULES CONSOLIDATING STATEMENTS OF INCOME BEECHNUT STREET, INC. AND SUBSIDIARIES Fiscal Year Ended May 31, 2013

	Beechnut Street, Inc.						
	BSI	Fondren I	Fondren II	HBHC	HBHP I	Eliminations	Consolidated
Operating Revenues and Support							
Rental revenue	\$ 89,000	\$ 909,287	\$ 486,817	\$ -	\$ 1,438,989	\$ -	\$ 2,924,093
Investment income	-	-	-	-	201	-	201
Other	-	4,173	477	-	11,685	-	16,335
Total operating revenues and support	89,000	913,460	487,294	-	1,450,875	-	2,940,629
Operating expenses:							
Selling, general, and administrative							
Plant	365,340	42,766	18,916	-	305,143	-	732,165
	18,457	165,014	67,839	-	425,201	-	676,511
Depreciation expense	2,002	26,982	45,300	-	240,091	-	314,375
Taxes	24,667	167,189	72,231	-	13,454	-	277,541
Other	-	109	-	-	13,500	-	13,609
Total operating expenses	410,466	402,060	204,286	-	997,389	-	2,014,201
Operating income (loss)	(321,466)	511,400	283,008	-	453,486	-	926,428
Non-operating expenses:							
Interest expense	-	(13,262)	(45,946)	-	(184,759)	-	(243,967)
Lease Expense (Paid To HBU)	-	(816,000)	(117,700)	-	(52,077)	-	(985,777)
Total non-operating expenses	-	(829,262)	(163,646)	-	(236,836)	-	(1,229,744)
Net income (loss)	(321,466)	(317,862)	119,362	-	216,650	-	(303,316)
Beginning equity (deficit)	(1,770,605)	(620,150)	1,110,769	(979)	851,460	(707,827)	(1,137,332)
Ending equity (deficit)	\$ (2,092,071)	\$ (938,012)	\$ 1,230,131	\$ (979)	\$ 1,068,110	\$ (707,827)	\$ (1,440,648)

See independent auditor's report

Consolidated Financial Statements Independent Auditor's Report

**Houston Baptist University and Subsidiary**

May 31, 2014 and 2013

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## **Independent Auditor's Report**

Board of Trustees  
Houston Baptist University

### **Report on the Financial Statements**

We have audited the accompanying consolidated financial statements of Houston Baptist University and its subsidiary (collectively, the "University"), which comprise the consolidated statements of financial position as of May 31, 2014 and 2013, and the related consolidated statements of activities, and cash flows for the years then ended, and the related notes to the financial statements.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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## **Independent Auditor's Report**

Page 2 of 2

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Houston Baptist University and its subsidiary as of May 31, 2014 and 2013, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

### ***Other Matter - Supplementary Information***

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying supplemental consolidating balance sheets and consolidating statements of income of Beechnut Street, Inc. and subsidiaries is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

### **Other Reporting Required by Government Auditing Standards**

In accordance with Government Auditing Standards, we have also issued our report dated September 10, 2014 on our consideration of Houston Baptist University and subsidiary's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards in considering Houston Baptist University and subsidiary's internal control over financial reporting and compliance.

*Fitts, Roberts & Co., P.C.*

Houston, Texas  
September 10, 2014

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**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**  
May 31, 2014 and 2013

	2014	2013
<b>Assets</b>		
Cash and cash equivalents	\$ 11,040,422	\$ 12,492,880
Receivables, principally from students, net of allowance for doubtful accounts of \$3,382,508 and \$2,484,214 in 2014 and 2013, respectively	3,509,183	3,182,712
Pledges receivable, net	5,518,341	3,420,237
Prepayments, inventories and other assets	1,600,967	1,388,618
Investments	84,819,655	77,722,263
Escrow funds	-	243,210
Investment in plant assets, net	124,344,562	120,326,608
Interests in perpetual trusts held by others	4,438,128	4,122,668
Interests in trusts administered by others	-	3,003
Cash, restricted	2,175,251	2,964,209
<b>TOTAL ASSETS</b>	<b>\$ 237,446,509</b>	<b>\$ 225,866,408</b>
<b>Liabilities and Net Assets</b>		
Accounts payable and accrued liabilities	\$ 7,635,755	\$ 7,368,344
Deferred income	424,739	409,454
Deposits and agency funds	1,356,979	1,120,113
Interest rate swap	4,675,251	5,464,209
Notes payable	24,707,030	20,772,900
Bonds payable	48,065,000	49,145,000
<b>TOTAL LIABILITIES</b>	<b>86,864,754</b>	<b>84,280,020</b>
Net Assets:		
Unrestricted	73,677,316	72,842,093
Temporarily restricted	32,170,245	24,561,993
Permanently restricted	44,734,194	44,182,302
<b>TOTAL NET ASSETS</b>	<b>150,581,755</b>	<b>141,586,388</b>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b>\$ 237,446,509</b>	<b>\$ 225,866,408</b>

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF ACTIVITIES**  
Fiscal Years ended May 31, 2014 and 2013

	Unrestricted		Temporarily Restricted		Permanently Restricted		Total	
	2014	2013	2014	2013	2014	2013	2014	2013
Operating revenues and support								
Tuition and fees	\$ 67,381,663	\$ 58,871,822	\$ -	\$ -	\$ -	\$ -	\$ 67,381,663	\$ 58,871,822
Funded	(5,148,795)	(5,100,103)	-	-	-	-	(5,148,795)	(5,100,103)
Unfunded	(26,664,211)	(22,460,464)	-	-	-	-	(26,664,211)	(22,460,464)
Tuition and fees, net	35,568,657	31,311,255	-	-	-	-	35,568,657	31,311,255
Private gifts and grants:								
Baptist General Convention of Texas	637,713	659,705	-	-	-	-	637,713	659,705
Government grants & contracts	2,919,543	2,941,071	248,577	217,705	-	-	3,168,120	3,158,776
Gifts in kind	12,902	121,031	-	-	-	-	12,902	121,031
Other	999,449	6,251,141	5,248,203	6,928,566	-	-	6,247,652	13,179,707
Investment and endowment income	1,179,222	1,239,189	596,395	473,608	-	-	1,775,617	1,712,797
Sales and services of auxiliary enterprises	7,230,037	6,199,505	-	9,195	-	-	7,230,037	6,208,700
Other	192,490	114,912	-	-	-	-	192,490	114,912
BSI revenue	3,217,690	2,940,629	-	-	-	-	3,217,690	2,940,629
Net assets released from restriction:								
Satisfaction of program restrictions	3,661,018	3,340,045	(3,661,018)	(3,340,045)	-	-	-	-
Total operating revenues and support	55,618,721	55,118,483	2,432,157	4,289,029	-	-	58,050,878	59,407,512
Operating Expenses:								
Educational and general:								
Instructional	17,740,983	17,216,430	-	-	-	-	17,740,983	17,216,430
Academic support	3,610,601	3,424,330	-	-	-	-	3,610,601	3,424,330
Student services	5,096,468	4,268,355	-	-	-	-	5,096,468	4,268,355
Institutional support	10,795,350	11,726,416	-	-	-	-	10,795,350	11,726,416
Total education and general	37,243,402	36,635,531	-	-	-	-	37,243,402	36,635,531
Auxiliary enterprises	14,422,086	13,279,753	-	-	-	-	14,422,086	13,279,753
BSI expenses (excluding interest)	2,241,026	2,079,212	-	-	-	-	2,241,026	2,079,212
Total operating expenses	53,906,514	51,994,496	-	-	-	-	53,906,514	51,994,496

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

**Houston Baptist University and Subsidiary**  
CONSOLIDATED STATEMENTS OF ACTIVITIES - CONTINUED  
Fiscal Years ended May 31, 2014 and 2013

	Unrestricted		Temporarily Restricted		Permanently Restricted		Total	
	2014	2013	2014	2013	2014	2013	2014	2013
EXCESS OF OPERATING REVENUES OVER OPERATING EXPENSES	\$ 1,712,207	\$ 3,123,987	\$ 2,432,157	\$ 4,289,029	\$ -	\$ -	\$ 4,144,364	\$ 7,413,016
Non-operating activities:								
Contributions	-	-	-	-	455,667	1,820,678	455,667	1,820,678
Net assets released from restrictions:								
Satisfaction of capital acquisition restrictions	737,944	506,788	(737,944)	(506,788)	-	-	-	-
Interest on indebtedness	(2,154,832)	(2,106,329)	-	-	-	-	(2,154,832)	(2,106,329)
Change in value of split interest agreements	-	-	216,232	391,799	96,225	101,848	312,457	493,647
Unrealized gain on investments	537,516	2,879,801	1,482,217	3,579,902	-	-	2,019,733	6,459,703
Realized gain on sale of investments	2,388	7,055	4,215,590	2,957,791	-	-	4,217,978	2,964,846
Total from non-operating activities	(876,984)	1,287,315	5,176,095	6,422,704	551,892	1,922,526	4,851,003	9,632,545
Change in net assets	835,223	4,411,302	7,608,252	10,711,733	551,892	1,922,526	8,995,367	17,045,561
Net assets - beginning of year	72,842,093	68,430,791	24,561,993	13,850,260	44,182,302	42,259,776	141,586,388	124,540,827
Net assets - end of year	<u>\$ 73,677,316</u>	<u>\$ 72,842,093</u>	<u>\$ 32,170,245</u>	<u>\$ 24,561,993</u>	<u>\$ 44,734,194</u>	<u>\$ 44,182,302</u>	<u>\$ 150,581,755</u>	<u>\$ 141,586,388</u>

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

**Houston Baptist University and Subsidiary**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
Fiscal Years ended May 31, 2014 and 2013

	2014	2013
Cash flows from operating activities:		
Change in net assets	\$ 8,995,367	\$ 17,045,561
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Realized (gain) on sale of investments	(4,217,978)	(2,964,846)
Unrealized (gain) on investments	(1,230,775)	(4,417,856)
(Gain) from bond interest swap	(788,958)	(2,041,847)
Gift of long lived assets and securities	-	(3,438,660)
Change in value of split-interest agreements and other trusts	(312,457)	(493,647)
Reinvested interest and dividends	(822,339)	(595,920)
Bad debt expense	645,075	911,555
Depreciation and amortization on investment in plant assets	5,134,133	4,951,119
Proceeds from contributions restricted for long-term investment	(455,667)	(1,820,678)
Changes in:		
Receivables, net	(971,546)	(701,707)
Pledges receivable, net	(2,098,104)	(2,846,854)
Prepayments, inventories, and other assets	(212,349)	13,368
Accounts payable and accrued liabilities	308,380	1,139,335
Deposits and agency funds	236,866	220,726
Deferred income	15,285	50,731
Net cash provided by operating activities	4,224,933	5,010,380
Cash flows from investing activities:		
Purchases of investments	(18,808,149)	(13,237,128)
Proceeds from sale of investments	17,981,850	16,490,195
Purchases of plant assets	(9,152,087)	(6,672,385)
Contractual payments on annuities	(40,970)	(41,695)
Net cash (used in) investing activities	(10,019,356)	(3,461,013)
Cash flows from financing activities:		
Proceeds from contributions restricted for long-term investment	455,667	1,820,679
Cash, restricted	1,032,168	3,463,101
Payments on bonds	(1,080,000)	(1,035,000)
Proceeds from notes payable	4,736,578	3,020,421
Payments on notes payable	(802,448)	(2,372,545)
Net cash provided by financing activities	4,341,965	4,896,656
Net (decrease) increase in cash and cash equivalents	(1,452,458)	6,446,023
Cash and cash equivalents at beginning of year	12,492,880	6,046,857
Cash and cash equivalents at end of year	<u>\$ 11,040,422</u>	<u>\$ 12,492,880</u>
Noncash transactions		
Retirement of plant assets	\$ 48,028	\$ 54,711

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



## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### **1. General**

Houston Baptist University (the “University”) is a private, non-profit institution of higher education based in Houston, Texas. The University is affiliated with the Baptist General Convention of Texas and provides education and training services primarily for students at the undergraduate and graduate levels. The University is a non-profit organization exempt from Federal income taxes under 501(a) as an organization described in Section 501(c)(3) of the Internal Revenue Code. The University is primarily supported by tuition and fees from students.

Beechnut Street, Inc. (“BSI”) is a wholly-owned for-profit subsidiary of the University’s Quasi Endowment Fund. BSI was established to hold and operate certain real estate and other investments. It owns a 21,953 square foot retail center and two adjoining ground leases situated on approximately 6.7 acres located on the northeast perimeter of the campus, known as Fondren II. In November 2007, BSI purchased Fondren I which consists of two in-line strip retail buildings containing 173,355 square feet, a freestanding retail store containing 9,000 square feet and one pad site improved with approximately 3,200 square feet of restaurant located on 15.2802 acres of land on the southeast corner of Fondren and US 59.

HB Housing Partnership I, LTD. (the “Partnership” or “HBHPI”) is a Texas Limited Partnership that operates the student housing apartment complex known as Husky Village. The Partnership commenced operations in March 1997 with two limited partners, HB Housing Corp (“HBHC”), a Texas Corporation, and BSI. The Partnership entered into an amended ground lease dated February 2003, with Houston Baptist University and constructed a 143 unit apartment complex in three phases, designed and financed by the Partnership, that houses students attending Houston Baptist University. During the year ended August 2004, BSI purchased the ownership interest of HBHC and the Partnership, along with HBHC, became wholly-owned by BSI.

The balance sheet and statement of income of the Partnership, HBHC, and BSI prior to consolidation with the University are included in the supplemental schedules to this report.

Bradshaw Recreation Center, Inc. (“BRC”), a non-profit organization under Section 501(c)(3) of the Internal Revenue Code, was formed in December 2011 to manage the operations of the Bradshaw Fitness Center. BRC is a wholly owned subsidiary of Houston Baptist University.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

##### **2. Basis of Presentation**

The consolidated financial statements include the accounts of the various academic and administrative divisions of the University, BRC, the Partnership and BSI. Inter-company balances and transactions are eliminated in consolidation.

Revenues, expenses, gains and losses are recorded on the accrual basis of accounting and are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the University are classified and reported as follows:

Permanently restricted - Net assets subject to donor-imposed stipulations that they be maintained permanently by the University. Generally, the donors of these assets permit the University to use all or part of the income earned on related investments for general or specific purposes. The income is included in temporarily restricted or unrestricted net assets as applicable.

Temporarily restricted - Net assets subject to donor-imposed stipulations that may or will be met either by actions of the University and/or the passage of time.

Unrestricted - Net assets that are not subject to donor-imposed stipulations.

Revenues from sources other than contributions are reported as increases in unrestricted net assets. Expenses are reported as decreases in unrestricted net assets. Gains or losses on investments are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulations or by law. Expirations of temporary restrictions recognized on net assets (e.g., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications from temporarily restricted net assets to unrestricted net assets. Temporary restrictions on gifts to acquire long-lived assets are considered met in the period in which the assets are acquired or placed in service.

Contributions, including unconditional promises to give, are recognized as revenues in the period received. Contributions of assets other than cash are recorded at their estimated fair value at the date of gift. Contributions to be received after one year are discounted at the three year treasury note rate. Amortization of the discount is recorded as additional contribution revenue in accordance with donor-imposed restrictions, if any, on the contributions. Allowance is made for uncollectible contributions based upon management's judgment and analysis of the creditworthiness of the donors, past collection experience and other relevant factors.

##### **3. Cash and Cash Equivalents**

Cash equivalents include time deposits, certificates of deposit, and highly liquid debt instruments with maturities of three months or less at date of acquisition.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

##### **4. Escrow Funds**

Escrow funds represent proceeds received from the note payable with a bank designated for the purchase and installation of equipment to be installed in various campus buildings and facilities.

##### **5. Accounts Receivable and Related Allowance for Doubtful Accounts**

Accounts receivable relate primarily to receivables from students. Tuition and registration charges relating to future semesters are recorded as deferred revenue when collected. Uncollected future fees are not recorded until the semester begins.

The estimated allowances for uncollectible accounts and notes receivable are accounted for using the reserve method. Under this method, allowances are maintained at a level which, in the judgment of management, is adequate to meet the present and potential risks of uncollectibility of the accounts and notes receivable. Management's judgment is based on a variety of factors, which include experience related to charge-offs and recoveries, and scrutiny of individual accounts and notes receivable. Amounts deemed by management to be uncollectible are charged to expense. Recoveries on receivables previously charged-off are credited to expense. Provisions for receivable losses are charged to expense and credited to the allowance for doubtful accounts.

##### **6. Inventories**

Inventories, which consist primarily of textbooks, clothing, gifts and supplies are stated at cost and are expensed using the first in, first out method.

##### **7. Investments**

Investments in corporate stocks and bonds are stated at quoted market value. Oil and gas royalty interests are valued by an independent appraiser. Other investments consist of a long term certificate of deposit which is carried at cost. Real estate is stated at fair market value as determined by independent appraisers. All real estate investments are held primarily for campus expansion and to function as sources of Quasi Endowment Fund income for the University. Real estate investment income is recognized net of related direct expenses. Investments in private investment funds are carried at net asset value as a practical expedient for determining fair values. The University may redeem its investments in private funds annually with 95 days notice.

Unrealized gains and losses resulting from increases and decreases in such fair market values are recognized during the period in which the change occurs.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued**

Pooled endowment and similar funds are invested on the basis of a total return policy to provide income and to realize appreciation in investment values. Amounts distributed from endowment funds to support operations for general or specific purposes are based on the trailing twelve quarter average market value of the investment pool.

#### **8. Restricted Cash**

Under the swap agreement between the University and Bank of America, the University is required to maintain a specified cash balance with the bank as collateral, if the swap liability exceeds a certain threshold. As of May 31, 2014 and 2013, the required balance was \$2,175,251 and \$2,964,209, respectively.

#### **9. Concentration of Credit Risk**

The University places its cash and cash equivalents with well capitalized financial institutions, which at times may exceed federally insured limits. The University has not experienced any losses of such accounts.

#### **10. Investment in Plant Assets**

Investment in plant assets are stated at cost less accumulated depreciation and amortization. Cost is determined by the purchase price or fair value, if acquired by gift. Campus land, construction in progress, and art and historical objects are not subject to depreciation or amortization. The University capitalizes items in excess of \$2,500 with a useful life of at least three years. Leasehold improvements are amortized over the shorter of the lease term or useful life of the asset. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets.

#### **11. Perpetual Trusts**

The University is the beneficiary of certain perpetual trusts held and administered by others, specifically the Baptist Foundation of Texas. The present values of the estimated future cash receipts from the trusts are recognized as assets and contribution revenues at the dates the trusts are established. Distributions of income from the trusts are recorded as contributions and the carrying value of the assets is adjusted for changes in the estimates of future receipts.

#### **12. Derivative Instruments and Hedging Activities**

The University follows FASB Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*, which establishes accounting and reporting standards for derivative instruments. Specifically, the standard requires all entities, including not-for-profit organizations, to recognize all derivatives as either assets or liabilities in their statement of financial position and to measure such instruments at fair value. Changes in the fair value of derivative financial instruments are recognized periodically as changes in net assets.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

##### **13. Functional Expenses**

Costs related to the operation and maintenance of physical plant, including depreciation and amortization of plant assets, are allocated to program and supporting activities based upon the percentage of total assets utilized by the applicable program or activity (see Note G).

##### **14. Advertising Costs**

Advertising costs are expensed as incurred. Advertising costs were approximately \$150,000 and \$1,218,000 for 2014 and 2013, respectively, and were charged to operating expenses.

##### **15. Operating Revenues and Support and Non-operating Activities**

Revenues and expenses included in operating revenues and support relate primarily to the University's educational mission. Non-operating activities include contributions to endowments, interest on indebtedness, and gains and losses on valuation and sales of assets.

##### **16. 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 judgments that affect the reported amounts of assets and liabilities and disclosures of contingencies at the date of the financial statements and revenues and expenses recognized during the reporting period. Significant estimates made by management include the estimated fair value of investments other than marketable securities (primarily real estate), the allowance for doubtful accounts, discounts on pledge receivables, the fair value of investments in perpetual trusts held by others, the estimated payable for life annuitants, and the fair value of the interest rate swap. Actual results could differ from those estimates.

##### **17. Fair Value Option**

FASB ASC 825 *Financial Instruments* permits entities to choose to measure certain financial instruments and other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. As permitted by the standard, management elects not to elect the fair value option, for the financial assets and liabilities that had not been previously carried at fair value.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE A - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

##### **18. Income Taxes**

The University follows ASC 740 which requires the evaluation of how tax positions should be recognized, measured, presented, and disclosed in the financial statements. The standard requires the evaluation of tax positions taken or expected to be taken in the course of preparing tax returns to determine whether the tax positions are “more-likely-than-not” of being sustained by the applicable taxing authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. The adoption of ASC 740 did not have an effect on the University’s net asset value, financial position or results of activities. As of May 31, 2014 and 2013 and for the years then ended, the University and its subsidiary, BSI, did not have an asset or liability for any unrecognized tax positions. Management’s determinations regarding ASC 740 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an on-going analysis of tax laws, regulations and interpretations thereof.

The University is subject to routine audits of the Internal Revenue Service. The University believes it is no longer subject to audits for years prior to 2011. The University’s policy is to classify income tax related interest and penalties in interest expense and other expense, respectively

##### **19. Recently Issued Accounting Standards**

Recent accounting pronouncements issued by the Financial Accounting Standards Board did not or are not believed by management to have a material impact on the University’s present or future financial statements.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE B - ALLOWANCE FOR DOUBTFUL ACCOUNTS

An allowance for doubtful accounts is provided against student receivables as discussed in Note A. The allowance for doubtful accounts at May 31, consists of the following:

	<u>2014</u>	<u>2013</u>
Allowance for doubtful accounts - beginning of year	\$ 2,484,214	\$ 2,584,258
Add: provision for doubtful accounts	645,075	911,555
Add: recovery of accounts written off	253,219	-
Less: accounts written off	<u>-</u>	<u>(1,011,599)</u>
Allowance for doubtful accounts - end of year	<u><u>\$ 3,382,508</u></u>	<u><u>\$ 2,484,214</u></u>

The provision for doubtful accounts is included in institutional support on the consolidated statements of activities.

#### NOTE C - PLEDGES RECEIVABLE, NET

Pledges receivable, net, at May 31, consists of the following:

	<u>2014</u>	<u>2013</u>
Unconditional promise expected to be collected in:		
Less than one year	\$ 971,215	\$ 770,836
Two to five years	4,321,850	2,210,838
Greater than five years	<u>300,000</u>	<u>450,000</u>
	5,593,065	3,431,674
Less unamortized discount	<u>(74,724)</u>	<u>(11,437)</u>
Total pledges receivable, net	<u><u>\$ 5,518,341</u></u>	<u><u>\$ 3,420,237</u></u>

Pledges receivable were discounted using rates ranging from .35% to .79%.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE D - INVESTMENTS

Investments at fair value, at May 31, consist of the following:

	<b>2014</b>	<b>2013</b>
Common stocks	\$ 22,092	\$ 22,092
Bonds	3,123,150	2,125,519
Mutual funds	45,063,405	39,057,064
Private investment fund	6,930,425	6,464,882
Real estate	27,963,978	27,887,705
Oil and gas royalty interests	1,651,605	2,100,001
Other investments	65,000	65,000
Total	<u>\$ 84,819,655</u>	<u>\$ 77,722,263</u>

The University nets investment fees against investment and endowment income. Investment fees were approximately \$177,000 and \$202,000 for the years ended May 31, 2014 and 2013, respectively.

#### NOTE E - RISKS AND UNCERTAINTIES

The University invests in various investment securities. Investment securities are exposed to various risks, such as interest rate, overall market volatility and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the University's account balances and the amounts reported in the statements of financial position.

#### NOTE F - SALE OF REAL ESTATE

In 2005, the University sold the right to use certain real estate assets held for investment (parcel 2) for approximately \$941,000. Under the terms of this agreement, the land and improvements will revert back to the University in the year 2020.

This transaction has been recorded as a sale of the property since the University will not have the right to the use of this land for approximately 14 years. Because the land and improvements will revert to the University, the current fair value of the property is being accrued into the financial statements over the 14 year period prior to the reversion of the land and improvements. The cumulative amount accrued as an asset and income for parcel 2 for the year ended May 31, 2014 was approximately \$674,000.



# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE G - INVESTMENT IN PLANT ASSETS, NET

Investment in plant assets, net, consists of the following at May 31:

	Estimated Useful Life	2014	2013
Buildings	20 - 50 years	\$ 114,729,420	\$ 110,861,817
Furniture, equipment, and library books	3 - 10 years	21,311,988	20,357,626
Land improvements	10 - 20 years	19,793,079	16,027,931
Software	10 years	2,388,387	2,388,388
Leasehold improvements	10 - 20 years	1,717,892	1,717,892
Vehicles	5 years	467,032	467,032
		<u>160,407,798</u>	<u>151,820,686</u>
Less accumulated depreciation and amortization		(52,453,296)	(47,367,190)
Campus land		6,360,248	6,360,248
Art and historical objects		6,091,511	6,048,511
Construction in progress		<u>3,938,301</u>	<u>3,464,353</u>
Total investment in plant assets		<u>\$ 124,344,562</u>	<u>\$ 120,326,608</u>

Depreciation and amortization expense for the years ended May 31, 2014 and 2013 was \$5,134,133 and \$4,951,119, respectively, and has been allocated to functional programs and supporting activities as follows:

Operation of plant expense for the years ended May 31, 2014 and 2013 was \$4,367,822 and \$4,154,550, respectively, and has been allocated to functional programs and supporting activities as follows:

	Depreciation and Amortization Expense		Operation of Plant Expense	
	2014	2013	2014	2013
Instructional	\$ 1,666,654	\$ 1,594,112	\$ 1,235,436	\$ 1,195,750
Academic support	352,916	337,555	261,605	253,201
Student services	289,895	277,278	214,889	207,986
Institutional support	579,790	554,555	429,779	415,974
Auxiliary enterprises	1,958,489	1,873,244	1,451,763	1,405,128
BSI	286,389	314,375	774,350	676,511
	<u>\$ 5,134,133</u>	<u>\$ 4,951,119</u>	<u>\$ 4,367,822</u>	<u>\$ 4,154,550</u>

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE H - DEBT

	<u>May 31, 2014</u>	<u>May 31, 2013</u>
<b><u>Bonds</u></b>		
Crawford Education Facilities Corporation ("CEFC") bonds, issued November 2007 in the amount of \$53,000,000 due in annual installments ranging from \$900,000 to \$3,220,000, beginning December 1, 2009 thru December 1, 2037. The interest rate is Securities Industry and Financial Markets Association ("SIFMA") plus 0.825%. On November 1, 2010, the bonds were remarketed publicly backed by a letter of credit from Bank of America. Under this agreement, the interest rate is SIFMA. At May 31, 2014, the interest rate was .18%. The bonds are secured by 6.686 acres of land, including improvements, and the future revenues of the University.	\$48,065,000	\$49,145,000
<b><u>Notes Payable</u></b>		
A note payable with a bank dated November 20, 2011 of \$5,839,182, requiring monthly principal and interest payments of \$35,880 with the balance due at maturity on November 20, 2029. The note bears interest at 3.25% and is secured by a ground lease on 7.6660 acres and all tenant rents and leases.	5,219,546	5,473,539
A note payable with a bank dated August 28, 2012 with a balance of \$1,354,629 at May 31, 2014. The note bears interest at the greater of the U.S. Prime Rate (as published by the Wall Street Journal) or 3.25%, and requires 84 monthly payments of principal and interest of \$23,452 beginning September 28, 2012 with all unpaid principal and accrued interest due at maturity on August 28, 2019. The note payable is secured by the 1st lien on Fondren II and all tenant rents and leases and is guaranteed by the University.	1,354,629	1,587,206
A note payable with a bank dated November 20, 2011 of \$419,718, requiring monthly payments of principal and interest of \$2,579, with the balance due at the maturity on November 20, 2029. The note payable bears interest at 3.25% and is secured by a ground lease on 7.6660 acres and all tenant rents and leases.	375,155	393,412

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE H – DEBT – Continued

A note payable with a non-profit organization dated January 1, 2012 of \$9,400,000, requiring 12 quarterly interest only payments through December 31, 2014. Quarterly principal and interest payments of \$143,138 begin March 31, 2015 through maturity at December 15, 2021, at which time any unpaid principal and accrued interest is due in full. The note bears interest at 4.5% and is secured by a building.

	9,400,000	9,400,000
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A note payable with a bank dated March 2, 2012 of \$2,676,530, requiring 29 quarterly principal payments of \$55,762 plus interest with the balance due at maturity on March 2, 2019. The note bears interest at 4.85% and is secured by all unrestricted gross revenues; all interest, dividends, cash, instruments and other property; escrow funds; and all other proceeds.

	2,341,958	2,565,006
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A note payable with a bank dated March 30, 2013 of \$6,000,000, of which \$6,000,000 and \$1,263,417 was funded as of May 31, 2014 and 2013, respectively, requiring 12 quarterly payments, with the first 3 being interest only payments on the funded amount of the loan. 9 quarterly payments of \$150,000 are scheduled to begin June 30, 2014 with balance due on March 31, 2016. The note bears a variable interest rate of LIBOR plus 1.0% and is secured with investments that are held at U.S. Trust.

	6,000,000	1,263,417
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#### Capital Leases

A capital lease arrangement with a leasing company dated August 14, 2009 of \$201,000, requiring 60 monthly payments of principal and interest of \$4,475 ending September 31, 2014.

	13,149	58,016
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A capital lease arrangement with a bank dated July 27, 2009 of \$129,792, requiring 60 monthly payments of principal and interest of \$2,599 ending July 31, 2014.

	2,593	32,304
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Total notes payable and capital leases

	24,707,030	20,772,900
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Total debt

	\$ 72,772,030	\$ 69,917,900
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## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE H – DEBT – Continued

Future minimum payments under this debt are as follows:

May 31,	Bonds	Notes payable	Capital leases	Total
2015	\$ 1,130,000	\$ 1,385,249	\$ 15,899	\$ 2,531,148
2016	1,180,000	6,318,523	-	7,498,523
2017	1,240,000	943,886	-	2,183,886
2018	1,295,000	969,721	-	2,264,721
2019	1,355,000	2,223,220	-	3,578,220
Thereafter	41,865,000	12,850,689	-	54,715,689
Subtotal	48,065,000	24,691,288	15,899	72,772,187
Less amounts representing interest	-	-	(157)	(157)
Total	<u>\$ 48,065,000</u>	<u>\$ 24,691,288</u>	<u>\$ 15,742</u>	<u>\$ 72,772,030</u>

Interest expense on notes and bonds payable for the years ending May 31, 2014 and 2013, respectively, was approximately \$2,155,000 and \$2,106,000. The interest paid on notes and bonds payable for the years ending May 31, 2014 and 2013, respectively, was approximately \$2,051,000 and \$2,121,000.

The Master Bond Agreement contains a swap provision. Effective February 1, 2008, the University executed two interest rate swaps in the amounts of \$26,000,000 and \$12,000,000. The swaps bear interest at 3.8275% and 3.395% and mature December 1, 2027 and February 1, 2018, respectively. The University entered into the agreement to lock in fixed interest rates on the variable rate debt and is not using the agreements for speculative purposes. The amount recorded in net assets for the changes in value of the instrument was an unrealized gain of \$789,000 and unrealized gain of \$2,042,000, at May 31, 2014 and 2013, respectively, and is included as an unrealized gain on sale of investments in the consolidated statements of activities.

# Houston Baptist University and Subsidiary

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts and estimated fair values of the University's financial instruments are as follows:

	2014		2013	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:				
Cash and cash equivalents	\$ 11,040,422	\$ 11,040,422	\$ 12,492,880	\$ 12,492,880
Receivables - principally from students, net	3,509,183	3,509,183	3,182,712	3,182,712
Pledges receivable, net	5,518,341	5,518,341	3,420,237	3,420,237
Investments:				
Common stocks	22,092	22,092	22,092	22,092
Bonds	3,123,150	3,123,150	2,125,518	2,125,518
Mutual funds	45,063,405	45,063,405	39,057,065	39,057,065
Private investment fund	6,930,425	6,930,425	6,464,882	6,464,882
Real estate	27,963,978	27,963,978	27,887,705	27,887,705
Oil and gas royalty interests	1,651,605	1,651,605	2,100,001	2,100,001
Certificate of deposit	65,000	65,000	65,000	65,000
Interests in perpetual trusts held by others	4,438,128	4,438,128	4,122,668	4,122,668
Interest in trusts administered by others	-	-	3,003	3,003
Financial liabilities:				
Accounts payable and accrued liabilities	7,834,440	7,834,440	7,368,344	7,368,344
Deposits and agency funds	1,356,979	1,356,979	1,120,113	1,120,113
Interest rate swap	4,675,251	4,675,251	5,464,209	5,464,209
Bonds payable	48,065,000	48,065,000	49,145,000	49,145,000
Notes payable	24,691,288	23,929,327	20,682,580	20,119,027
Capital leases payable	15,742	15,742	90,320	90,320

The methods and assumptions used to estimate the fair value of each class of financial instruments are as follows:

#### Cash and cash equivalents

The carrying amount approximates fair value due to the short maturity of those instruments.

#### Receivables- principally from students - net

The carrying amount approximates fair value based on the short maturities of accounts receivable.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued**

##### Pledges receivable - net

The fair value of pledges receivable is based on the discounted value of expected future cash flows.

##### Investments

Corporate stocks and bonds and real estate are carried at market value; therefore, the carrying value approximates fair value. Other investments consist of a long-term certificate of deposit carried at amortized cost which approximates fair value.

##### Interests in perpetual trusts held by others

The interests in trusts held by others are carried at fair value which is determined using the net asset value of shares held by the trusts.

##### Interests in trusts administered by others

The interests in trusts administered by others are carried at fair value which is determined using the net asset value of shares held by the trusts.

##### Accounts payable, accrued liabilities, deposits and agency funds

The carrying amount approximates fair value because of the short maturity of the financial instruments.

##### Bonds payable

The carrying value approximates fair value based on the variable interest rates of the bonds payable.

##### Interest rate swap

The interest rate swap is carried at fair value as determined by using current market rates.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

##### Notes payable

The estimated fair value of notes payable is based on discounting future cash flows using current interest rates at which similar loans could be obtained for the same remaining maturities.

The University follows the fair value guidance for its financial assets and liabilities. The guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability, in an orderly transaction between market participants at the measurement date. The guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The three levels of inputs that may be used to measure fair value:

- Level 1: Inputs based on quoted market prices for identical assets or liabilities in active markets at the measurement date.
- Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. The inputs are unobservable in the market and significant to the instruments valuation.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

The following table classifies the University's financial assets and liabilities measured at fair value on a recurring basis as of May 31, 2014:

Description	May 31, 2014	Level 1	Level 2	Level 3
<b>Financial assets:</b>				
Investments:				
Common stocks by sector:				
Basic material	\$ 22,092	\$ 22,092	\$ -	\$ -
Bonds:				
US Corporate	3,123,150	-	3,123,150	-
Mutual funds:				
Stocks	38,781,436	35,661,916	3,119,520	-
Bonds	6,281,969	3,990,161	2,291,808	-
Certificate of deposit	65,000	65,000	-	-
Private investment fund	6,930,425	-	6,930,425	-
Real estate	27,963,978	-	-	27,963,978
Oil and gas royalty interest	1,651,605	-	-	1,651,605
Interest in perpetual trusts held by others	4,438,128	-	4,438,128	-
Total investments at fair value	<u>\$ 89,257,783</u>	<u>\$ 39,739,169</u>	<u>\$ 19,903,031</u>	<u>\$ 29,615,583</u>
<b>Financial liabilities:</b>				
Interest rate swap	<u>\$ 4,675,251</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 4,675,251</u>

The University has made capital commitments to the investment manager of the private investment fund of \$5,434,000. As of May 31, 2014, all of this capital commitment has been funded.



## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

The following table classifies the University's financial assets and liabilities measured at fair value on a recurring basis as of May 31, 2013:

Description	May 31, 2013	Level 1	Level 2	Level 3
<b>Financial assets:</b>				
Investments:				
Common stocks by sector:				
Basic material	\$ 22,092	\$ 22,092	\$ -	\$ -
Bonds:				
US Corporate	2,125,518	-	2,125,518	-
Mutual funds:				
Stocks	33,048,454	28,265,542	4,782,912	-
Bonds	6,008,611	2,342,160	3,666,451	-
Certificate of deposit	65,000	65,000	-	-
Private investment fund	6,464,882	-	6,464,882	-
Real estate	27,887,705	-	-	27,887,705
Oil and gas royalty interest	2,100,001	-	-	2,100,001
Interest in perpetual trusts held by others	4,122,668	-	4,122,668	-
Interests in trusts administered by others	3,003	-	3,003	-
			-	
Total investments at fair value	<u>\$ 81,847,934</u>	<u>\$ 30,694,794</u>	<u>\$ 21,165,434</u>	<u>\$ 29,987,706</u>
<b>Financial liabilities:</b>				
Interest rate swap	<u>\$ 5,464,209</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 5,464,209</u>

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE I - FAIR VALUE OF FINANCIAL INSTRUMENTS – Continued

The schedule below reconciles the opening balance to the closing balance for the year ended May 31, 2014 for the items on the previous table which have been classified as Level 3:

	Real estate	Oil and gas Royalty interests	Interest rate swap
Balance, beginning of year	\$ 27,887,705	\$ 2,100,001	\$ (5,464,209)
Total gains (losses)			
Included in unrealized gain/ (loss) on investments	76,273	(448,396)	788,958
Balance, end of year	<u>\$ 27,963,978</u>	<u>\$ 1,651,605</u>	<u>\$ (4,675,251)</u>

The schedule below summarizes the activity for the year ended May 31, 2013 for the items on the previous table which have been classified as Level 3:

	Real estate	Oil and gas Royalty interests	Interest rate swap
Balance, beginning of year	\$ 24,731,432	\$ 1,533,409	\$ (7,506,056)
Total gains (losses)			
Included in unrealized gain/ (loss) on investments	156,273	566,592	2,041,847
Purchase/(Sales) of investments	3,000,000	-	-
Balance, end of year	<u>\$ 27,887,705</u>	<u>\$ 2,100,001</u>	<u>\$ (5,464,209)</u>

Total Level 3 gains or losses above are all included in the consolidated statements of activities, and all relate to financial assets and liabilities still held at year end.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE J - RETIREMENT PLAN AND TUITION REIMBURSEMENT**

In 1963, the University established a retirement plan for all regular full-time faculty members and administrative staff. In compliance with the Tax Reform Act of 1986, the plan (a defined contribution plan) was amended in January 1989. Employees who complete one year of service and who work a total of 1,000 hours during a calendar year are eligible to participate. Upon an employee reaching eligibility, contributions are made to the plan by the University in an amount equal to 5% of the participant's salary. Contributions to the Plan by the University were approximately \$968,000 and \$861,000 for 2014 and 2013, respectively. In addition, at the discretion of the University, the University may elect to make a matching contribution equal to the participant's contribution, not to exceed 2.5% of the participant's salary. Effective June 1, 2009, the University temporarily suspended the discretionary matching contribution.

Employees may make voluntary contributions up to the limit allowed by law. Effective January 1, 1992, retirement benefits for new employees vest 100% after five years of employment. Participants in the plan prior to January 1, 1992 are fully vested from the time of initial contribution. Participants can elect to retire at various ages under the plan with the earliest being at age 55.

Effective January 1, 2007 in an effort to encourage long-term continuous service, faculty and staff members who have completed ten continuous years of fulltime employment at the University are eligible for tuition benefits for their children to attend other universities. An eligible faculty or staff member may receive up to 80% of the tuition remission amount that would have been received had the child attended the University. For the years ended May 31, 2014 and 2013 approximately \$3,000 and \$20,000 were expensed, respectively. After the fall term of 2009, this long-term tuition benefit was discontinued, though some grandfathered benefits are still being paid.

Also, faculty or staff members who have completed six months of continuous fulltime employment at the University prior to the first day of the academic semester are eligible for tuition benefits for themselves as well as eligible spouses and children. For the years ended May 31, 2014 and 2013, respectively, approximately \$525,000 and \$359,000 were expensed for faculty, staff, and their spouses and children.

#### **NOTE K - TRUST FUNDS HELD BY OTHERS**

The University is the beneficiary of several trust funds administered primarily by the Baptist Foundation of Texas. No provision has been made for releasing trust principal to the University, except for the payment of specific capital improvements authorized under specified conditions of each trust. The amount of original trust principal has a fair value of approximately \$4,438,000 and \$4,126,000 on May 31, 2014 and 2013, respectively. Income distributions from these funds were approximately \$258,000 and \$215,000 in 2014 and 2013, respectively.

The University is the beneficiary of trust funds from various estates. Substantially all distributions from such trust funds are royalty income and totaled approximately \$313,000 and \$189,000 in 2014 and 2013, respectively, and are recorded in investment and endowment income.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE L – NET ASSETS

Temporarily restricted net assets consist of the following at May 31:

	2014	2013
Pledges receivable principally for student, facilities and campus enhancements	\$ 4,154,632	\$ 2,172,037
Net cumulative income from endowment funds – (including unrealized gains) primarily for scholarships	19,208,832	15,252,582
Trusts held by others	2,151,817	1,935,585
Student scholarships and loans	565,437	461,572
Equipment, renovations and operations	6,135,233	4,852,664
Life annuity funds	(45,706)	(112,447)
Total	<u>\$ 32,170,245</u>	<u>\$ 24,561,993</u>

Permanently restricted net assets and the purpose for which the income from those net assets is expendable are as follows:

	2014	2013
General endowment funds	\$ 36,422,736	\$ 35,951,055
Endowed academic scholarship funds	7,901,641	7,818,396
Life annuity funds	182,501	185,505
Student loan funds	227,316	227,346
Total	<u>\$ 44,734,194</u>	<u>\$ 44,182,302</u>

#### NOTE M - DEVELOPMENT EXPENSES

The University incurred expenses totaling approximately \$1,184,000 and \$1,106,000 for the years ended May 31, 2014 and 2013, respectively, related to development and fund-raising. Such amounts are included in institutional support expenses in the accompanying consolidated statements of activities.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE N - COMMITMENTS AND CONTINGENCIES

The University is the lessor of operating leases with third parties expiring in various years through 2022. Minimum future rental income under non-cancelable operating leases having remaining terms in excess of one year as of May 31 are:

	<u>University</u>	<u>BSI</u>	<u>Total</u>
2015	\$ 438,555	\$ 771,228	\$ 1,209,783
2016	222,364	429,472	651,836
2017	126,449	261,025	387,474
2018	228,181	101,826	330,007
2019	179,378	115,653	295,031
Thereafter	<u>231,361</u>	<u>322,865</u>	<u>554,226</u>
Total minimum future rental income	<u>\$1,426,288</u>	<u>\$2,002,069</u>	<u>\$3,428,357</u>

Rental income for the years ended May 31, 2014 and 2013 was approximately \$2,153,000 and \$2,179,000, respectively, and has been included in the investment and endowment income and BSI revenue on the consolidated statements of activities.

The University participates in various federal loan programs. In March 2010, Congress passed the Health Care and Education Reconciliation Act of 2010. Under this act, the federal government stopped giving subsidies to private banks to give out federally insured loans. Instead, loans will be administered directly by the Department of Education. Subsequent to the passing of this Act, the Federal Direct Loan Program is the sole government-backed loan program in the United States, replacing the Federal Family Education Loan Program. The amount of loans disbursed under the Direct Loan Program for the years ended May 31, 2014 and 2013 was approximately \$22,147,000 and \$17,883,000, respectively. Amounts questioned as a result of audits, if any, may result in the University purchasing the loan(s) from the lender as the loan(s) may have lost its (their) guaranteed status. Management believes that such amounts, if any, would be immaterial to the financial statements.

Activity of the Pell Grant program is not reflected in the consolidated statements of activities as the transactions are considered to be agency transactions. Students received approximately \$4,237,000 and \$3,939,000 from the Federal Pell Grant programs during fiscal years 2014 and 2013, respectively.

The University participates in various federal Title IV financial aid programs. The Department of Education requires private nonprofit institutions to demonstrate financial responsibility by meeting certain ratio requirements. The University was in compliance with these requirements at May 31, 2014 and May 31, 2013.

## **Houston Baptist University and Subsidiary**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

#### **NOTE O - ENDOWMENTS**

The University's endowment consists of approximately 365 individual funds established for a variety of purposes. Its endowment includes both donor-restricted endowment funds and funds designated by the Board of Trustees to function as endowments. As required by generally accepted accounting principles ("GAAP"), 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 Board of Trustees of the University has interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value 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 donated 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 in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization 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 donor-restricted 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 policy of the University.

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE O - ENDOWMENTS - Continued**

**2014**

**Endowment Net Asset Composition by Type of Fund as of May 31, 2014**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$21,314,924	\$44,734,194	\$66,049,118
Board-designated endowment Funds	24,589,419	-	-	24,589,419
<b>Total Funds</b>	<b>\$24,589,419</b>	<b>\$21,314,924</b>	<b>\$44,734,194</b>	<b>\$90,638,537</b>

**Changes in Endowment Net Assets for the Fiscal Year Ended May 31, 2014**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$24,166,686	\$17,118,385	\$44,182,302	\$85,467,373
Investment return:				
Investment income	310,758	528,520	-	839,278
Net appreciation (realized and unrealized)	(364,288)	5,998,820	96,225	5,730,757
Total investment return	(53,530)	6,527,340	96,225	6,570,035
Rental income	661,918	13,404	-	675,322
BSI revenue	3,217,891	-	-	3,217,891
Contributions	-	9,300	455,667	464,967
Appropriation of endowment assets for expenditure	(804,248)	(2,265,567)	-	(3,069,815)
Other changes:				
BSI expenses	(2,241,028)	-	-	(2,241,028)
Interest expense	(237,782)	-	-	(237,782)
Miscellaneous income/(expense)	(205,269)	(3,157)	-	(208,426)
Intercompany adjustment	84,781	(84,781)	-	-
<b>Endowment net assets, end of year</b>	<b>\$24,589,419</b>	<b>\$21,314,924</b>	<b>\$44,734,194</b>	<b>\$90,638,537</b>

**Houston Baptist University and Subsidiary**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**NOTE O - ENDOWMENTS - Continued**

**2013**

**Endowment Net Asset Composition by Type of Fund as of May 31, 2013**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$ 17,118,385	\$44,182,302	\$61,300,687
Board-designated endowment Funds	24,166,686	-	-	24,166,686
<b>Total Funds</b>	<b>\$24,166,686</b>	<b>\$17,118,385</b>	<b>\$44,182,302</b>	<b>\$85,467,373</b>

**Changes in Endowment Net Assets for the Fiscal Year Ended May 31, 2013**

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$22,988,423	\$11,872,160	\$42,259,776	\$77,120,359
Investment return:				
Investment income	298,725	416,069	-	714,794
Net appreciation (realized and unrealized)	711,024	7,086,115	101,848	7,898,987
Total investment return	1,009,749	7,502,184	101,848	8,613,781
Rental income	723,245	-	-	723,245
BSI revenue	2,940,629	-	-	2,940,629
Contributions	-	-	1,820,678	1,820,678
Appropriation of endowment assets for expenditure	(1,311,071)	(2,095,936)	-	(3,407,007)
Other changes:				
BSI expenses	(2,014,201)	-	-	(2,014,201)
Interest expense	(243,967)	(3,400)	-	(247,367)
Miscellaneous income/(expense)	(82,744)	-	-	(82,744)
Intercompany adjustment	156,623	(156,623)	-	269,202
<b>Endowment net assets, end of year</b>	<b>\$24,166,686</b>	<b>\$17,118,385</b>	<b>\$44,182,302</b>	<b>\$85,467,373</b>



## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE O - ENDOWMENTS - Continued

##### Description of Amounts Classified as Permanently Restricted Net Assets and Temporarily Restricted Net Assets (Endowment Only)

	<u>May 31, 2014</u>	<u>May 31, 2013</u>
<b>Temporarily Restricted Net Assets</b>		
The portion of perpetual endowment funds subject to a time restriction under UPMIFA:		
Without purpose restrictions	\$ 3,243,253	\$ 2,848,658
With purpose restrictions	<u>18,071,671</u>	<u>14,269,727</u>
<b>Total endowment funds classified as temporarily restricted net assets</b>	<u>\$21,314,924</u>	<u>\$17,118,385</u>
<b>Permanently Restricted Net Assets</b>		
The portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or by UPMIFA		
<b>Total endowment funds classified as permanently restricted net assets</b>	<u>\$44,734,194</u>	<u>\$44,182,302</u>

#### **1. Funds with Deficiencies**

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires the University to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature are \$85,000 and \$156,000 as of May 31, 2014 and May 31, 2013, respectively and are included in satisfaction of program restrictions on the Consolidated Statement of Activities. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new permanently restricted contributions and continued appropriation for certain programs was deemed prudent by the Board of Trustees of the University.

#### **2. Return Objectives and Risk Parameters**

The University has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the real purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the University must hold in perpetuity or for a donor-specified period(s) as well as board-designated funds. Under this policy, as approved by the Board of Trustees, the endowment assets are invested in a manner that is intended to produce results that earn an average rate of return at least equal to the nominal spending rate policy plus the rate of inflation plus an additional return of 1%, net of all fees, including management advisory fees and custody charges, over the long term (defined as rolling 5 year periods).

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE O - ENDOWMENTS - Continued

##### 3. Strategies Employed for Achieving Objectives

To achieve its investment objective, the Fund's assets are considered to be divided into two major components: Drivers of Return and Risk Reducing assets. The Investment Committee will determine the classification of alternative or market neutral investments. The Fund's long-term commitment to these classes shall be:

	<u>Range</u>	<u>Long-term Target</u>
Drivers of return	55%-75%	65%
Risk reducing assets	25%-45%	35%

##### 4. Spending Policy and How the Investment Objectives Relate to Spending Policy

The University has a policy of appropriating for distribution each year 5 percent of its endowment fund's average fair value over the prior 12 quarters through the fiscal year ended preceding the fiscal year in which the distribution is planned. In establishing this policy, the University considered the long-term expected return on its endowment. Accordingly, over the long-term, the University expects the current spending policy to allow its endowment to grow. This is consistent with the University's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return.

#### NOTE P - RELATED PARTY TRANSACTIONS

During the year, the University made payments to various vendors who meet the requirements of a related party. The nature of these transactions is described below:

- A consultant firm was engaged to provide enrollment management strategy services to the University during the year ended May 31, 2007. The Chairman of the Board of the holding company which owns the firm, and who is also a principle owner of the firm, served as the Chairman of the Board of Trustees of the University until November 2012. The former board member became an owner in this firm subsequent to the initial contract between the University and the firm. In addition, the University's Vice President of Enrollment Services is a paid consultant for the firm. Total fees paid to this company were \$68,000 and \$64,000 for the years ended May 31, 2014 and 2013, respectively.
- A firm that provides property management services was engaged by the University's for-profit subsidiary, Beechnut Street, Inc. to manage its retail space in July 2010. The firm's Senior Vice President is the brother of the University's Vice President for Financial Operations. Total fees paid to this firm by the University were \$14,000 and \$52,000 for the years ended May 31, 2014 and 2013, respectively.

## Houston Baptist University and Subsidiary

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

#### NOTE P - RELATED PARTY TRANSACTIONS - Continued

BSI holds the ground lease for three properties that are owned by the University. They are the Fondren I Shopping Center, the Fondren II Shopping Center and the Husky Village Apartments. The amount of rental income for Fondren I paid by BSI to the University for the years ended May 31, 2014 and 2013, respectively, was approximately \$816,000 and \$816,000, which eliminates in consolidation. The amount of rental income for Fondren II paid by BSI to the University for the years ended May 31, 2014 and 2013, respectively, was approximately \$118,000 and \$118,000, which eliminates in consolidation. The amount of rental income for Husky Village paid by BSI to the University for the years ended May 31, 2014 and 2013, respectively, was approximately \$54,000 and \$52,000, which eliminates in consolidation.

#### NOTE Q – SACS CORE REQUIREMENT 2.11.1

The University is a member of the Southern Association of Colleges and Schools (“SACS”). As part of the reaffirmation process with SACS, the University must comply with core requirements, as outlined in *The Principles of Accreditation: Foundations for Quality Enhancement*. Core requirement 2.11.1 requires a separate financial schedule calculating unrestricted net assets, exclusive of plant assets and plant related debt, as follows:

	May 31, 2014	May 31, 2013
Unrestricted net assets	\$ 73,677,316	\$ 72,842,093
Less: Investment in campus plant	(124,344,562)	(113,008,704)
Add: Interest rate swap derivative related to campus plant debt	4,675,251	5,464,209
Add: Debt related to campus plant	72,772,030	62,463,743
Unrestricted net assets, exclusive of plant and plant related debt	<u>\$ 26,780,035</u>	<u>\$ 27,761,341</u>

#### NOTE R – LITIGATION

The University and its subsidiary are subject to legal actions arising in the ordinary course of business. Management does not believe that the outcome of any legal actions would have a material adverse affect on the consolidated financial position or changes in its net assets.

#### NOTE S – SUBSEQUENT EVENTS

The University has evaluated all events that occurred between May 31, 2014 and September 10, 2014, the date the consolidated financial statements were available to be issued. The letter of credit related to the CEFC bonds was amended on June 18, 2014 and extended the letter of credit agreement until July 1, 2015. The University is not aware of any other subsequent events which would require recognition or disclosure in the consolidated financial statements.

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## **Supplementary Information**

**Houston Baptist University and Subsidiary**

SUPPLEMENTAL SCHEDULES  
CONSOLIDATING BALANCE SHEETS  
BEECHNUT STREET, INC. AND SUBSIDIARIES  
May 31, 2014

	<b>Beechnut Street, Inc.</b>						
	<b>BSI</b>	<b>Fondren I</b>	<b>Fondren II</b>	<b>HBHC</b>	<b>HBHP I</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Assets</b>							
Cash and cash equivalents	\$ 19,226	\$ 2,972	\$ 36,546	\$ -	\$ 805,489	\$ -	\$ 864,233
Accounts receivables	-	4,000	4,277	-	-	-	8,277
Prepays and other assets	-	8,580	-	-	-	-	8,580
Investment in subsidiary	707,827	-	-	-	-	(707,827)	-
Investments in real estate	1,447,636	-	-	-	-	-	1,447,636
Plant, property, and equipment, net accumulated depreciation of \$3,567,446 in 2014.	29,311	1,059,564	627,699	-	5,314,941	-	7,031,515
Receivable from University	-	-	-	-	507,052	-	507,052
Intercompany Receivable	-	-	2,307,858	-	19,496	(2,327,354)	-
<b>TOTAL ASSETS</b>	<b>\$ 2,204,000</b>	<b>\$ 1,075,116</b>	<b>\$ 2,976,380</b>	<b>\$ -</b>	<b>\$ 6,646,978</b>	<b>\$ (3,035,181)</b>	<b>\$ 9,867,293</b>
<b>Liabilities and Net Assets</b>							
Accounts payable and accrued expenses	15,115	99,173	41,821	-	120,240	-	276,349
Payable to University	2,847,258	1,364,161	237,114	979	-	-	4,449,512
Deferred revenues	-	3,100	13,573	-	-	-	16,673
Notes payable	-	375,155	1,354,629	-	5,219,546	-	6,949,330
Intercompany payable	1,812,878	514,476	-	-	-	(2,327,354)	-
<b>Total liabilities</b>	<b>4,675,251</b>	<b>2,356,065</b>	<b>1,647,137</b>	<b>979</b>	<b>5,339,786</b>	<b>(2,327,354)</b>	<b>11,691,864</b>
Shareholders' equity (deficit)	(2,471,251)	(1,280,949)	1,329,243	(979)	1,307,192	(707,827)	(1,824,571)
<b>Total liabilities and shareholders' equity (deficit)</b>	<b>\$ 2,204,000</b>	<b>\$ 1,075,116</b>	<b>\$ 2,976,380</b>	<b>\$ -</b>	<b>\$ 6,646,978</b>	<b>\$ (3,035,181)</b>	<b>\$ 9,867,293</b>

*See independent auditor's report.*

**Houston Baptist University and Subsidiary**

SUPPLEMENTAL SCHEDULES  
CONSOLIDATING STATEMENTS OF INCOME  
BEECHNUT STREET, INC. AND SUBSIDIARIES  
Fiscal Year Ended May 31, 2014

	<b>Beechnut Street, Inc.</b>						
	<b>BSI</b>	<b>Fondren I</b>	<b>Fondren II</b>	<b>HBHC</b>	<b>HBHP I</b>	<b>Eliminations</b>	<b>Consolidated</b>
Operating Revenues and Support							
Rental revenue	\$ 110,125	\$ 921,607	\$ 460,233	\$ -	\$ 1,712,226	\$ -	\$ 3,204,191
Investment income	-	-	-	-	202	-	202
Other	-	122	23	-	13,353	-	13,498
Total operating revenues and support	110,125	921,729	460,256	-	1,725,781	-	3,217,891
Operating expenses:							
Selling, general, and administrative	365,654	53,332	25,619	-	321,725	-	766,330
Plant	27,449	199,615	53,192	-	494,094	-	774,350
Depreciation expense	2,272	26,982	46,168	-	210,967	-	286,389
Taxes	24,301	150,156	67,919	-	19,201	-	261,577
Other	8	5,906	1,406	-	145,062	-	152,382
Total operating expenses	419,684	435,991	194,304	-	1,191,049	-	2,241,028
Operating income (loss)	(309,559)	485,738	265,952	-	534,732	-	976,863
Non-operating expenses:							
Interest expense	-	(12,675)	(48,745)	-	(176,362)	-	(237,782)
Lease Expense (Paid To HBU)	-	(816,000)	(117,695)	-	(53,951)	-	(987,646)
Other intercompany income	(69,620)	-	-	-	(65,339)	-	(134,959)
Total non-operating expenses	(69,620)	(828,675)	(166,440)	-	(295,652)	-	(1,360,387)
Net income (loss)	\$ (379,179)	\$ (342,937)	\$ 99,512	\$ -	\$ 239,080	\$ -	\$ (383,524)
Beginning equity (deficit)	(2,092,072)	(938,012)	1,229,731	(979)	1,068,112	(707,827)	(1,441,047)
Ending equity (deficit)	<u>\$ (2,471,251)</u>	<u>\$ (1,280,949)</u>	<u>\$ 1,329,243</u>	<u>\$ (979)</u>	<u>\$ 1,307,192</u>	<u>\$ (707,827)</u>	<u>\$ (1,824,571)</u>

*See independent auditor's report.*