

BEREA COLLEGE

Financial Statements
for the Year Ended June 30, 2004

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HIGHLIGHTS

| | June 30, | |
|---|----------------|-----------------|
| | 2004 | 2003 |
| OPERATING REVENUE | \$ 59,179,429 | \$ 59,487,716 |
| OPERATING EXPENSES | \$ 55,426,358 | \$ 56,171,523 |
| OPERATING REVENUE IN EXCESS OF EXPENSES FROM CONTINUING OPERATIONS | \$ 3,753,071 | \$ 3,316,193 |
| ADDITIONS TO PROPERTY, PLANT AND EQUIPMENT | \$ 14,128,513 | \$ 25,229,309 |
| LONG-TERM INVESTMENTS OF THE ENDOWMENT AND TUITION REPLACEMENT FUNDS | | |
| Original gift value | \$ 291,178,337 | \$ 270,794,617 |
| Investments at market | \$ 794,962,600 | \$ 695,812,000 |
| Interest and dividends, net | \$ 15,088,772 | \$ 14,802,646 |
| Return | 2.2% | 2.3% |
| Market price increase (decrease) | \$ 100,426,969 | \$ (14,420,253) |
| Return | 14.2% | -2.0% |
| Total return | \$ 115,515,741 | \$ 382,393 |
| Percent | 16.4% | 0.3% |
| CASH AND IN-KIND CONTRIBUTIONS | | |
| Cash gifts | \$ 9,974,728 | \$ 12,110,515 |
| Bequests | 16,802,567 | 11,710,149 |
| Total cash gifts | 26,777,295 | 23,820,664 |
| Gifts-in-kind | 43,586 | 172,527 |
| Total | \$ 26,820,881 | \$ 23,993,191 |

REPORT OF THE ACTING VICE PRESIDENT FOR FINANCE

August, 2004

To the Board of Trustees, President Shinn,
And Friends of Berea College,

As we complete another fiscal year, we celebrate the privilege of being part of the Berea learning community, committed to preparing young people to make a positive difference in the world. As we worked together at Berea College this past year, we have engaged in thinking openly and creatively about the ways in which Berea will continue to provide students with the highest quality undergraduate experience possible. However, this commitment of providing an excellent learning environment and experience brings special financial challenges.

Over the years, there has been an increasing demand on the earnings of the endowment to provide the financial support for Berea's operating budget. The endowment spending formula now provides 76% of the revenue for the College's educational and general operating budget. Through prudent asset allocation and positive equity markets, the endowment provided a total return of 16.4% before spending in 2003-04. During the year, the endowment experienced a net market-price increase of more than \$100 million, and over \$20 million was added to the endowment as a result of \$19 million in endowment fund gifts and approximately \$1 million in matured planned giving instruments.

Berea experienced the best fund-raising year in its history, recording a total of \$26.8 million in gifts. Of this total, approximately \$4.2 million was designated for current operations and the remainder was designated for the endowment or for specific projects or purposes. Another record was set during 2003-04 when alumni gave their alma mater over \$1 million!

In September 2003, the College began the public phase of its \$150 million comprehensive fund-raising campaign. Campaign proceeds will fund several specific initiatives identified by the strategic planning process and scholarships for Berea students in such areas as technology, international study and sustainability programs.

Four building renovation projects were completed during the year, including Lincoln Hall and Presser Hall. The newly renovated Lincoln Hall is the first LEED (Leadership in Energy & Environmental Design) certified building in Kentucky, and Presser Hall has been redesigned to provide superb working and learning environments for faculty and students. Also during the year, an asset purchase agreement was completed between the College and the City of Berea for the sale of certain Electric and Water Utility assets. Some proceeds from the sale, which is expected to be completed by December 31, 2004, will be utilized for funding the construction of a new campus heat plant which is expected to be operational by August 2006.

Berea continues to actively strive to increase the diversity of its student body. In Fall 2003, 17% of first-year students were African American; in Fall 2004 this percentage has continued to increase. Furthermore, Berea's African American students are graduating at the same rate as other Berea students, which greatly exceeds national rates for predominantly white institutions. Approximately 40 states and over 75 foreign countries are represented by Berea's student body, and over 40% of recent graduates have reported participating in international experiences while at the College.

Financial Position

The College maintains its strong financial position. As of June 30, 2004, *total net assets* (total assets less liabilities) of the College approximated \$923.6 million for an increase of \$108.3 million from the previous year. This change reflects an increase in the market value of long-term investments during the year from \$736.7 million as of June 30, 2003, to \$838.3 million as of June 30, 2004.

At June 30, 2004, *total assets* of Berea College were \$1 billion. Of this amount, long-term investments (including endowment funds, annuity and life income funds and other funds) comprised \$838.3 million; property, plant and equipment, and bond proceeds for capital additions net of depreciation totaled \$120.8 million; long-lived assets held for sale totaled \$17.1 million; and current assets totaled over \$29.2 million. Contributions receivable and bequests in probate totaled \$8.0 million; non-current prepaid expenses totaled \$2.2 million; and student educational loans totaled approximately \$1.9 million.

Total liabilities increased by approximately \$4.4 million primarily due to the issuance of \$5 million in long-term debt to fund renovations of a residence hall. This increase in total liabilities was partially offset by the payment of current maturities of long-term debt of approximately \$1 million.

Current Operations

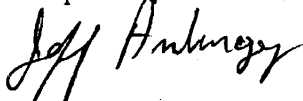
The 2003-04 fiscal year ended with a surplus from budgeted operations of over \$785,000. This surplus was due to the realization of more Berea Fund gifts along with less than budgeted administrative salaries and net controllable expenses. In the full consolidation of all activities, the College experienced \$3.7 million of operating revenue in excess of expenses from continuing operations.

Concluding Comments

Berea is indeed a wonderful learning community and is fortunate to have such a strong, enthusiastic and caring faculty and staff to nurture its students to their full potential. These promising students, and the alumni they become, so ably demonstrate through their many successes the positive outcomes of a Berea College education. The exceptional leadership of the Board of Trustees, along with the tremendous generosity of Berea's alumni and many friends, sustain the unique Berea mission and ensure the promise of Berea College to future generations. For your role in this mission, whether as student, faculty, staff, alumni, trustee or friend, we truly thank you.

We look forward to another challenging and rewarding year at Berea College and invite you to visit soon. Your presence is always welcome on the campus of Berea College.

Respectfully submitted,



Jeff Amburgey
Acting Vice President for Finance

Deloitte

To the Board of Trustees
Berea College
Berea, Kentucky

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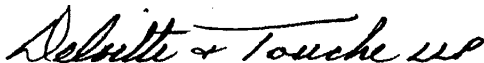
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We have audited the accompanying statements of financial position of Berea College (College) as of June 30, 2004 and 2003, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the College's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the College as of June 30, 2004 and 2003, and the related 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.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental data listed in the table of contents is presented for the purpose of additional analysis and is not a required part of the basic financial statements. This supplemental data is the responsibility of the College's management. Such supplemental data has not been subjected to the auditing procedures applied in our audits of the basic financial statements and, accordingly, we express no opinion on it.



August 27, 2004

Berea College

STATEMENTS OF FINANCIAL POSITION

| | June 30, | |
|---|-------------------------|-----------------------|
| | 2004 | 2003 |
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 15,437,784 | \$ 15,464,725 |
| Other investments - absolute return fund | 6,438,516 | 3,280,296 |
| Accrued interest on investments | 3,122,039 | 2,311,094 |
| Accounts and notes receivable | 1,954,297 | 1,755,485 |
| Inventories | 2,266,210 | 2,307,258 |
| Prepaid expenses and other assets | 28,905 | 28,905 |
| Total current assets | <u>29,247,751</u> | <u>25,147,763</u> |
| NON-CURRENT PREPAID EXPENSES AND OTHER ASSETS | <u>2,210,400</u> | <u>1,044,349</u> |
| CONTRIBUTIONS RECEIVABLE AND BEQUESTS IN PROBATE | <u>7,959,088</u> | <u>6,313,721</u> |
| LONG-TERM RECEIVABLES | | |
| Institutional student loans | 1,536,865 | 1,477,133 |
| Federal student loans | 324,999 | 301,097 |
| Total long-term receivables | <u>1,861,864</u> | <u>1,778,230</u> |
| LONG-TERM INVESTMENTS | | |
| Donor-restricted endowment | 440,447,600 | 386,166,800 |
| Tuition replacement | 354,515,000 | 309,645,200 |
| Annuity and life income | 25,522,500 | 24,401,000 |
| Funds held in trust by others | 17,844,000 | 16,438,300 |
| Total long-term investments | <u>838,329,100</u> | <u>736,651,300</u> |
| BOND PROCEEDS FOR CAPITAL ADDITIONS | <u>1,096,152</u> | <u>5,470,706</u> |
| LONG-LIVED ASSETS HELD FOR SALE | <u>17,089,750</u> | <u>-</u> |
| NET PROPERTY, PLANT AND EQUIPMENT | <u>119,730,433</u> | <u>128,455,143</u> |
| Total assets | <u>\$ 1,017,524,538</u> | <u>\$ 904,861,212</u> |

See notes to financial statements.

Berea College

STATEMENTS OF FINANCIAL POSITION

| | June 30, | |
|---|------------------------|-----------------------|
| | 2004 | 2003 |
| LIABILITIES AND NET ASSETS | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 4,493,085 | \$ 4,313,037 |
| Accrued salaries and wages | 2,464,723 | 2,565,354 |
| Deposits and agency funds | 553,588 | 525,921 |
| Deferred income | 98,601 | 47,660 |
| Current maturities of long-term debt | 1,767,470 | 1,015,225 |
| Total current liabilities | <u>9,377,467</u> | <u>8,467,197</u> |
| LONG-TERM LIABILITIES | | |
| Annuity payment/deferred giving liability and other liabilities | 12,528,400 | 11,726,600 |
| Long-term debt | 72,044,085 | 69,401,556 |
| Total long-term liabilities | <u>84,572,485</u> | <u>81,128,156</u> |
| Total liabilities | <u>93,949,952</u> | <u>89,595,353</u> |
| NET ASSETS | | |
| Unrestricted - | | |
| For current operations | 82,899 | 79,456 |
| Designated for specific purposes | 24,705,081 | 22,955,817 |
| Invested in property, plant and equipment | 27,223,842 | 24,775,794 |
| Support of future operations from: | | |
| Contributions receivable and bequests in probate | 3,981,717 | 1,799,599 |
| Appreciation on endowment investments | 232,533,565 | 200,408,653 |
| Tuition replacement funds | 354,515,000 | 309,645,200 |
| Total unrestricted | <u>643,042,104</u> | <u>559,664,519</u> |
| Temporarily restricted - | | |
| Unexpended contributions restricted for operations | 4,948,118 | 4,571,806 |
| Unexpended contributions restricted for plant renewals and replacement | 1,522,702 | 3,970,416 |
| Annuity and life income contracts | 6,763,287 | 6,636,730 |
| Expended contributions for long-lived assets being amortized | 28,457,528 | 25,995,950 |
| Appreciation on endowment investments primarily to support various programs/services | 61,262,687 | 49,549,132 |
| Total temporarily restricted | <u>102,954,322</u> | <u>90,724,034</u> |
| Permanently restricted - | | |
| Loan funds | 3,154,970 | 2,966,926 |
| Annuity and life income contracts | 6,394,813 | 6,037,670 |
| Funds held in trust by others | 17,844,000 | 16,438,300 |
| Endowment investments | 150,184,377 | 139,434,410 |
| Total permanently restricted | <u>177,578,160</u> | <u>164,877,306</u> |
| Total net assets | <u>923,574,586</u> | <u>815,265,859</u> |
| Total liabilities and net assets | <u>\$1,017,524,538</u> | <u>\$ 904,861,212</u> |

See notes to financial statements.

STATEMENTS OF ACTIVITIES

Changes in Unrestricted Net Assets

| | Year Ended June 30, | |
|--|---------------------|-----------------|
| | 2004 | 2003 |
| OPERATING REVENUE | | |
| Spendable return from long-term investments | \$ 33,281,631 | \$ 34,299,979 |
| Gifts and donations | 4,324,604 | 4,890,623 |
| Federal grants, primarily for student labor | 4,278,006 | 4,149,121 |
| Cost of education fees paid by federal and state scholarships | 2,500,000 | 2,514,418 |
| Fees paid by students | 1,005,301 | 935,212 |
| Other income | 3,521,447 | 2,965,793 |
| Residence halls and food service | 5,482,487 | 4,987,433 |
| Student industries and rentals | 3,361,490 | 3,252,540 |
| Net assets released from restrictions | 4,161,046 | 4,122,021 |
| | 61,916,012 | 62,117,140 |
| Gross operating revenue | | |
| Less: Student aid | (2,736,583) | (2,629,424) |
| | 59,179,429 | 59,487,716 |
| OPERATING EXPENSES | | |
| Program Services - | | |
| Instruction | 18,721,009 | 18,369,714 |
| Public service | 3,165,589 | 3,027,213 |
| Academic support | 5,934,172 | 8,050,926 |
| Student services | 7,547,427 | 7,203,419 |
| Residence halls and food service | 5,497,343 | 5,049,893 |
| Student industries and rentals | 4,001,402 | 3,917,711 |
| | 44,866,942 | 45,618,876 |
| Total Program Services | | |
| Support Services, including fund raising expense of \$2,708,600 in 2004 and \$2,521,900 in 2003 | 10,559,416 | 10,552,647 |
| | 55,426,358 | 56,171,523 |
| Total operating expenses | | |
| Operating revenue in excess of operating expenses from continuing operations | 3,753,071 | 3,316,193 |
| Gain on disposal of property, plant and equipment | 255,459 | 576,304 |
| Income from discontinued operations | 273,903 | 454,806 |
| | 67,063,018 | (32,483,060) |
| REVENUES DESIGNATED FOR LONG-TERM INVESTMENT | | |
| Unrestricted bequests | 11,587,291 | 4,142,902 |
| Matured annuity and life income contracts | 444,843 | 611,815 |
| Investment return in excess of (less than) amounts designated for current operations | 67,063,018 | (32,483,060) |
| | 79,095,152 | (27,728,343) |
| Total increase (decrease) in revenues designated for long-term investment | | |
| Increase (decrease) in unrestricted net assets | \$ 83,377,585 | \$ (23,381,040) |

See notes to financial statements.

STATEMENTS OF ACTIVITIES

Changes in Total Net Assets

| | Year Ended June 30, | |
|---|---------------------|----------------|
| | 2004 | 2003 |
| UNRESTRICTED NET ASSETS | | |
| Operating revenue in excess of operating expenses from continuing operations | \$ 3,753,071 | \$ 3,316,193 |
| Gain on sale of property, plant and equipment | 255,459 | 576,304 |
| Income from discontinued operations | 273,903 | 454,806 |
| Increase (decrease) in revenues designated for long-term investment | 79,095,152 | (27,728,343) |
| Increase (decrease) in unrestricted net assets | 83,377,585 | (23,381,040) |
| TEMPORARILY RESTRICTED NET ASSETS | | |
| Restricted gifts and donations | 1,855,087 | 2,245,253 |
| Restricted spendable return on endowment investments | 3,221,390 | 3,664,498 |
| Investment return in excess of (less than) amounts designated for current operations | 11,703,861 | (5,365,022) |
| Net adjustment of annuity payment and deferred giving liability | 55,839 | (579,773) |
| Reclassification of net assets released from restrictions | (4,161,046) | (4,122,021) |
| Reclassification of matured annuity and life income contracts to revenues designated for long-term investment | (444,843) | (611,815) |
| Increase (decrease) in temporarily restricted net assets | 12,230,288 | (4,768,880) |
| PERMANENTLY RESTRICTED NET ASSETS | | |
| Gifts and donations | 10,699,267 | 7,212,333 |
| Restricted spendable return on endowment investments | 245,841 | 265,998 |
| Restricted capital gains (losses) on funds held in trust by others | 1,405,700 | (116,900) |
| Net adjustment of annuity payment and deferred giving liability | 350,046 | (252,830) |
| Increase in permanently restricted net assets | 12,700,854 | 7,108,601 |
| Total change in net assets | 108,308,727 | (21,041,319) |
| NET ASSETS | | |
| Beginning of year | 815,265,859 | 836,307,178 |
| End of year | \$ 923,574,586 | \$ 815,265,859 |

See notes to financial statements.

STATEMENTS OF CASH FLOWS

| | Year Ended June 30, | |
|---|----------------------|----------------------|
| | 2004 | 2003 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Increase (decrease) in net assets | \$ 108,308,727 | \$ (21,041,319) |
| Adjustments to reconcile change in net assets to net cash provided or used by operating activities - | | |
| Market price (increase) decrease on long-term investments | (80,330,799) | 37,964,982 |
| Gifts and bequests for financing activities | (22,528,506) | (12,108,229) |
| (Increase) decrease in contributions receivable and bequests in probate | (1,645,367) | 5,583,873 |
| Gift value of annuity contracts written | (1,067,671) | (1,100,142) |
| Depreciation | 5,736,886 | 4,642,903 |
| Gain on disposal of property, plant and equipment | (255,459) | (576,304) |
| Net adjustment of annuity payment liability and other long-term liabilities other than long-term debt | (241,885) | 832,603 |
| Increase in non-current prepaid expenses and other assets | (1,166,051) | (210,109) |
| Increase in current assets other than cash and other investments | (968,709) | (262,322) |
| Increase (decrease) in current liabilities other than current maturities of long-term debt | 158,025 | (1,119,281) |
| Restricted spendable return on endowment funds | (245,841) | (265,998) |
| Net cash provided by operating activities | <u>5,753,350</u> | <u>12,340,657</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchases of securities held for long-term investment | (660,083,438) | (311,962,895) |
| Proceeds from sales and maturities of investments | 642,952,771 | 301,784,235 |
| Purchase of other investments - absolute return fund | (3,000,000) | (141,872) |
| Purchase of property, plant and equipment | (14,128,513) | (25,229,309) |
| Proceeds from sale of property, plant and equipment | 282,046 | 623,195 |
| Long-term student loans | (438,046) | (365,182) |
| Long-term student loan repayments | 354,412 | 296,537 |
| Gain on annuity and life income investments | 2,275,145 | 587,594 |
| Net cash used by investing activities | <u>(31,785,623)</u> | <u>(34,407,697)</u> |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Gifts and bequests received for - | | |
| Long-term investment | 21,710,475 | 10,575,448 |
| Property, plant and equipment | 794,058 | 1,510,161 |
| Student loans | 23,973 | 22,620 |
| Proceeds received on annuity and life income contracts | 1,653,094 | 1,761,314 |
| Contractual payments on annuity and life income contracts | (1,816,883) | (1,817,970) |
| Third party payments of matured annuity and life income contracts | - | (30,198) |
| Endowment return restricted for long-term investments | 245,841 | 265,998 |
| Repayment of indebtedness | (28,295,226) | (933,468) |
| Long-term debt issued | 31,690,000 | 18,500,000 |
| Net cash provided by financing activities | <u>26,005,332</u> | <u>29,853,905</u> |
| Net change in cash and cash equivalents | (26,941) | 7,786,865 |
| Cash and cash equivalents, beginning of year | <u>15,464,725</u> | <u>7,677,860</u> |
| Cash and cash equivalents, end of year | <u>\$ 15,437,784</u> | <u>\$ 15,464,725</u> |

See notes to financial statements.

NOTES TO FINANCIAL STATEMENTS

(1) SUMMARY OF ACCOUNTING POLICIES

General

Berea College (the College) is a not-for-profit institution providing liberal arts education to students with limited family financial resources primarily from the Southern Appalachian Mountain region. All students are provided a full tuition scholarship and, accordingly, the College is dependent on gifts and donations to help provide a low cost but high quality education. The College has one campus located in Berea, Kentucky with an enrollment of approximately 1,500 students and approximately 570 employees.

Basis of Presentation

The financial statements have been prepared on the accrual basis of accounting. The preparation of financial statements in accordance 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, liabilities and disclosures of contingencies at the date of the financial statements and revenues and expenses recognized during the reporting period. Actual results could differ from those estimates.

Under established financial reporting standards for not-for-profit organizations, net assets and revenues, expenses, and gains and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets and changes therein are classified as follows:

Permanently restricted net assets - Net assets subject to donor-imposed stipulations that they be maintained permanently by the College. Generally, the donors of these assets permit the institution to use all or part of the income earned on related investments for general or specific purposes.

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

Unrestricted net assets - Net assets not subject to donor-imposed stipulations.

Revenues from sources other than contributions are reported as increases in unrestricted net assets. Contributions are reported as increases in the appropriate category of net assets, except that contributions which impose restrictions that are met in the same fiscal year they are received are included in unrestricted revenues. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulations or by law. Expirations of temporary restrictions on net assets (i.e., 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.

Contributions, including unconditional promises to give and bequests, are recognized as revenues in the period received. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair value at the date of the gift. Contributions to be received after one year are discounted at a rate commensurate with the risk involved. Amortization of the discount is recorded as additional contribution revenue and used 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.

NOTES TO FINANCIAL STATEMENTS

(1) SUMMARY OF ACCOUNTING POLICIES (continued)

Contributions of exhaustible long-lived assets, or of cash or other assets to be used to acquire them, without donor stipulations concerning the use of such long-lived assets, are reported as revenues of the temporarily restricted net asset class; the restrictions are considered to be released over the estimated useful lives of the long-lived assets using the College's depreciation policies.

All contributions of works of art, historical treasures and similar assets, whether held as part of a collection (for education, research or public exhibition rather than for sale) or for sale or other purposes, have been recognized at their estimated fair value at the date of receipt based upon appraisals or similar valuations. All such items, whether contributed or purchased, have been capitalized.

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market.

Investments

Investments are reported at their respective fair values. The values of publicly traded fixed income and equity securities are based upon quoted market prices. Private equities, including real estate partnerships, and certain other nonmarketable securities are valued using information provided by the general partner or investment manager for the respective funds. Other real estate investments are stated at cost on the date of acquisition or fair market value at date of receipt in the case of gifts. Net realized and unrealized gains and losses on investments are reflected in the statements of activities.

The College's investments do not have a significant concentration of credit risk within any industry or specific institution.

The market risk inherent in certain of the College's investments is primarily the potential loss arising from adverse changes in quoted market prices on equity securities and in interest rates on fixed income securities. Investment securities, in general, are exposed to various risks, such as interest rates, credit and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the statement of financial position. In an effort to mitigate this market risk, the College has adopted a policy of maintaining a diverse investment pool through the use of target asset allocation guidelines. These guidelines require that the College's investment pool be made up of a mix of publicly traded fixed income and equity securities, private equities and other nonmarketable securities, and real estate investments.

Derivatives

Derivative instruments, including certain derivative instruments embedded in other contracts, are valued at fair value and are included in the statement of financial position. The change in fair value of such instruments is included in the statement of activities.

Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation.

NOTES TO FINANCIAL STATEMENTS

(1) SUMMARY OF ACCOUNTING POLICIES (continued)

Depreciation on the property, plant and equipment owned by the College has been computed using the following composite depreciation guidelines:

| | |
|---------------------------------------|---------------|
| Buildings and additions | 75 years |
| Building improvements and renovations | 15 - 30 years |
| Furniture, equipment and books | 10 years |
| Electric and water utility property | 10 - 80 years |

Using these guidelines and guidelines established by the Kentucky Public Service Commission for utility properties, depreciation expense for 2004 and 2003 was:

| | <u>2004</u> | <u>2003</u> |
|------------------------------------|---------------------|---------------------|
| Educational and general properties | \$ 4,545,654 | \$ 3,667,721 |
| Student industry equipment | 451,287 | 320,393 |
| Utility plant and equipment | <u>739,945</u> | <u>654,789</u> |
| | <u>\$ 5,736,886</u> | <u>\$ 4,642,903</u> |

Unrestricted Bequests

The College follows the policy of designating all unrestricted bequests as additions to the tuition replacement funds. Such bequests are reported as revenues designated for long-term investment in the statements of activities.

Cash Flow Information

For financial statement purposes, the College considers all investments (not held for long-term investment) with original maturities of three months or less as cash equivalents.

Cash payments for interest amounted to \$3,063,030 in 2004 and \$2,014,788 in 2003.

Functional Allocation of Expenses

The costs of providing the various programs and supporting services have been summarized on a functional basis in the statements of activities. Certain costs have been allocated among the programs and supporting services benefited.

NOTES TO FINANCIAL STATEMENTS

(2) LONG-TERM INVESTMENTS

| | June 30, | |
|--|----------------|----------------|
| | 2004 | 2003 |
| Endowment and Tuition Replacement: | | |
| Pooled Investments - | | |
| Domestic common stocks | \$ 326,826,400 | \$ 334,752,200 |
| International common stocks | 152,755,600 | 127,579,500 |
| Corporate notes and bonds | 74,856,900 | 72,328,100 |
| U. S. Government securities | 52,708,500 | 20,380,500 |
| Foreign bonds | 1,066,700 | 1,398,500 |
| Structured notes | 54,366,700 | - |
| Private equity, venture capital and other | 57,293,100 | 59,940,200 |
| Hedge funds | 31,482,900 | 31,272,100 |
| Real estate | 16,852,500 | 25,434,200 |
| Short-term investments and cash | 22,822,300 | 18,811,700 |
| Total | 791,031,600 | 691,897,000 |
| Non Pooled Investments - | | |
| Domestic common stocks | 262,100 | 205,900 |
| Real estate | 2,772,900 | 2,772,900 |
| Short-term investments and cash | 896,000 | 936,200 |
| Total | 3,931,000 | 3,915,000 |
| Total endowment and tuition replacement | 794,962,600 | 695,812,000 |
| Annuity and Life Income: | | |
| Pooled Annuity Investments - | | |
| Domestic common stocks | 8,579,100 | 8,287,000 |
| International common stocks | 1,324,300 | 2,019,400 |
| Corporate notes and bonds | 3,162,200 | 1,345,600 |
| U. S. Government securities | - | 379,200 |
| Foreign bonds | - | 26,000 |
| Real estate | - | 524,800 |
| Short-term investments and cash | 392,700 | 367,400 |
| Total | 13,458,300 | 12,949,400 |
| Separately Invested Trusts - | | |
| Common stocks | 6,008,400 | 3,834,000 |
| International common stocks | 591,400 | - |
| Corporate notes and bonds | 3,833,400 | 4,310,100 |
| U. S. Government securities | 455,800 | 2,016,800 |
| Real estate | 525,000 | 525,000 |
| Short-term investments and cash | 650,200 | 765,700 |
| Total | 12,064,200 | 11,451,600 |
| Total annuity and life income | 25,522,500 | 24,401,000 |
| Funds Held in Trust by Others, where Berea College receives all or a stipulated percent of income | | |
| | 17,844,000 | 16,438,300 |
| Total long-term investments | \$ 838,329,100 | \$ 736,651,300 |

NOTES TO FINANCIAL STATEMENTS

(2) LONG-TERM INVESTMENTS (continued)

The hedge funds in which the College invests may include, but are not necessarily limited to, equity securities, short sales positions, distressed securities, fixed income securities, options, currencies, commodities, futures and derivatives. The College's objective for investing in these funds is to provide stable, absolute returns that are uncorrelated to fluctuations in the stock and bond markets.

The majority of the private equity partnerships, including buy-out, venture capital, debt, and real estate partnerships are carried at estimated fair value provided by management of these funds. Certain of the investments are carried at fair value as determined by the fund managers at March 31, adjusted by cash receipts, cash disbursements and cash distributions from March 31 through June 30. Because these investments are not readily marketable, the estimated value is subject to uncertainty and, therefore, may differ from the value that may have been used had a ready market existed and such difference could be material.

The College's investment objective for its pooled long-term investments is to provide a predictable and growing stream of inflation-adjusted spendable return while maintaining the real (inflation-adjusted) value of the pooled investments. In connection with these investment objectives, the Board of Trustees has adopted a spending formula for determining that part of total return which can be expended annually.

The College has an endowment spending formula which utilizes a 5% spending rate of the prior twelve quarter moving average of the market value of the long-term pooled investments. For 2004 and 2003, spendable return under the formula amounted to \$36,824,780 and \$38,826,639, respectively. In 2004, actual cash income earned on pooled investments, net of \$1,603,948 for investment management and custodial fees, amounted to \$15,164,691, or \$21,660,089 less than the spendable return provided by the formula. This difference was taken from the accumulated net appreciation earned on investments.

Effective October 1, 2003, the gift annuity contracts were transferred from the pooled long-term investments to a trust company. The trust company is responsible for the administration and investment management of the gift annuity contracts.

The College follows the policy of spending only cash income received on non-pooled endowment investments. Such income amounted to \$95,351 in 2004 and \$145,042 in 2003, while the market value of these investments of \$3,931,000 at June 30, 2004 and \$3,915,000 at June 30, 2003 increased by \$13,500 in 2004 and decreased by \$88,206 in 2003. Net additions to non-pooled endowment investments during 2004 amounted to \$2,500 and no transfers were made to pooled investments.

Dividend and interest income included in the statements of activities of \$15,260,042 and \$15,543,851 for the years ended June 30, 2004 and 2003 is reported net of external investment manager fees of \$1,603,948 and \$1,344,815, respectively.

(2) LONG-TERM INVESTMENTS (continued)

During 2004, the unit value of pooled investments changed as follows:

| | 2003-04 | | | 2002-03 | |
|--------------------------------------|----------------------|------------------|--------------------|----------------------------------|----------------------|
| | Market Value | Number of Units | Value Per Unit | Total Return Percent Net of Fees | Market Value |
| Beginning Balance | \$704,846,400 | 606,997.1 | \$ 1,161.20 | | \$726,387,400 |
| Gift annuities transferred from pool | (12,949,400) | (11,139.5) | | | - |
| Balance after transfer | <u>691,897,000</u> | <u>595,857.6</u> | | | <u>726,387,400</u> |
| Market price change | 100,413,469 | - | 167.77 | 14.2% | (15,064,142) |
| Net income earned | 15,164,691 | - | 25.45 | 2.2% | 15,398,809 |
| Spendable return | (36,824,780) | - | (61.50) | - | (38,826,639) |
| | <u>78,753,380</u> | | <u>131.72</u> | <u>16.4%</u> | <u>(38,491,972)</u> |
| Additions | <u>20,381,220</u> | <u>15,959.5</u> | - | | <u>16,950,972</u> |
| Ending Balance | <u>\$791,031,600</u> | <u>611,817.1</u> | <u>\$ 1,292.92</u> | | <u>\$704,846,400</u> |

The total return earned by the endowment and charitable gift annuity contract investments for the years ended June 30, was:

| | 2004 | 2003 |
|--|----------------------|-------------------|
| Pooled Investments - | | |
| Cash income, net | \$ 15,164,691 | \$ 15,398,809 |
| Market price increase (decrease) | 100,413,469 | (15,064,142) |
| Non-Pooled Investments - | | |
| Cash income | 95,351 | 145,042 |
| Market price increase (decrease) | 13,500 | (88,206) |
| Total Return | 115,687,011 | 391,503 |
| Less: Charitable Gift Annuity Contracts | | |
| Cash income | (171,270) | (741,205) |
| Market price decrease | - | 732,095 |
| Endowment return | 115,515,741 | 382,393 |
| Distributed to - | | |
| Unrestricted Net Assets | | |
| Spendable return | 33,281,631 | 34,299,979 |
| Long-term investments | 67,063,018 | (32,483,060) |
| Temporarily Restricted Net Assets | | |
| Spendable return | 3,221,390 | 3,664,498 |
| Investment return in excess of (less than) amounts designated for current operations | 11,703,861 | (5,365,022) |
| Permanently Restricted | | |
| Restricted earnings | <u>245,841</u> | <u>265,998</u> |
| Total | <u>\$115,515,741</u> | <u>\$ 382,393</u> |

NOTES TO FINANCIAL STATEMENTS

(3) DERIVATIVE FINANCIAL INSTRUMENTS

The College uses certain derivative financial instruments to maximize investment income to meet target investment returns and to hedge currency exposures on investments in foreign securities. The fair market value of these contracts is reported as a part of the fair value of the underlying financial instruments.

The College also uses interest rate swaps to reduce exposure to fluctuations in interest costs on its variable rate debt. During 2004, the College entered into interest rate swap contracts with UBS AG. The contracts were designed to reduce the interest rate risk to the College from the underlying variable rate bonds that were issued August 2002 for \$18,500,000 and the variable rate bonds that were issued December 2003 for \$10,240,000. The contracts call for UBS AG to pay the College the variable rate interest based on The Bond Market Association Municipal Swap Index (TBMA) until July 1, 2005, and 70% of the 30-day LIBOR rate for the remaining term of the bonds. The fair market value of the interest rate swaps was \$1,060,900 at June 30, 2004 and is included in non-current prepaid expenses and other assets in the statements of financial position.

(4) DEFINED CONTRIBUTION RETIREMENT PLAN

The College has a defined contribution retirement plan covering all employees with one or more years of service. Costs of the plan are expensed as incurred and aggregated \$1,724,546 in 2004 and \$1,757,796 in 2003.

(5) PROPERTY, PLANT AND EQUIPMENT

The major categories of property, plant and equipment as of June 30 were:

| <u>Property, Plant and Equipment</u> | <u>2004</u> | <u>2003</u> |
|---|-----------------------|-----------------------|
| Educational property, plant and equipment | \$ 138,886,644 | \$ 126,425,871 |
| Electric and water utility plant | 2,454,444 | 27,248,886 |
| Student industry plant and equipment | 8,094,268 | 8,147,653 |
| Rental property | 2,897,954 | 2,698,911 |
| Forest and farms | 717,179 | 583,658 |
| Collections and works of art | 3,101,031 | 3,101,031 |
| Less accumulated depreciation | (36,421,087) | (39,750,867) |
| | <u>\$ 119,730,433</u> | <u>\$ 128,455,143</u> |

(6) LONG-LIVED ASSETS HELD FOR SALE

On July 26, 2004 the Executive Committee of the Board of Trustees, empowered to act for and on behalf of the Board of Trustees, approved the Utility Asset Purchase Agreement between the College and the City of Berea executed by the President of the College and dated June 18, 2004. The agreement provides for the sale of certain Electric and Water Utility assets to the City of Berea. No significant gain or loss is expected from the sale. Net operating results of the Electric and Water Utilities are reflected in discontinued operations in the statements of activities. After the sale, the College will purchase electricity and water from the City of Berea.

NOTES TO FINANCIAL STATEMENTS

(7) LONG-TERM DEBT

| | June 30, | |
|---|------------|--------------|
| | 2004 | 2003 |
| KDFA Loan Agreement - Issued June 1986; due in monthly installments to June 2011; variable interest rate, 2.42% as of June 2004; unsecured; proceeds used for various capital projects | \$ 936,555 | \$ 1,036,781 |
| General Obligation Bonds, Series of 1993 - Issued May 1993, due May 2013 at 5.9%; unsecured; proceeds used for electric utility improvements | 3,500,000 | 3,500,000 |
| Educational Development Bonds of 1994 - Issued March 1994, due March 1, 2014 at 5.45%; unsecured; proceeds used for Physical Education/Convocation Center | - | 5,000,000 |
| General Obligation Bonds, Series of 1997 - Issued June 1997, due June 2017 at 5.9%; unsecured; proceeds used to refinance electric and water utility debt | 6,000,000 | 6,000,000 |
| Educational Buildings Revenue Bonds, Series of 1997 - Issued August 1997; serial annual payments through August 2017 at rates from 4.5% to 5.0%; unsecured; proceeds used for Frost Building restoration and renovation | 2,375,000 | 2,490,000 |
| General Obligation Refunding Bonds, Series of 1998 - Issued July 1, 1998, serial annual payments through 2008 at rates from 4.1% to 4.8%; unsecured; proceeds used to retire bonds used for water filtration plant and other water utility improvements | 2,325,000 | 2,700,000 |
| Educational Development Bonds, Series of 1998 - Issued December 1, 1998; Serial Annual Payments through December 2018 at rates from 4.0% to 4.65%; proceeds used for residence hall and administrative building renovation | 7,055,000 | 7,390,000 |
| Educational Development Revenue Bonds, Series of 2000 - Issued May, 2000; serial annual payments through 2020 at rates from 4.6% to 5.7%; unsecured; proceeds used for residence hall renovation | 2,260,000 | 2,350,000 |
| Variable Rate Demand Educational Facilities Revenue Bonds, Series 2001A - Issued June 1, 2001; variable payments through June 1, 2031; variable interest rate, 0.98% as of June 2003; unsecured; proceeds used for various capital projects | - | 21,450,000 |

NOTES TO FINANCIAL STATEMENTS

(7) LONG-TERM DEBT (continued)

| | June 30, | |
|---|---------------|---------------|
| | 2004 | 2003 |
| Variable Rate Demand Educational Facilities Revenue Bonds, Series 2002A - Issued August 29, 2002; variable payments through June 1, 2032; variable interest rate, 1.05% as of June, 2004; with synthetic fixed rate of 3.45%; unsecured; proceeds used for various capital projects | \$ 18,110,000 | \$ 18,500,000 |
| Educational Facilities Revenue Refunding Bonds, Series 2003A - Issued July 8, 2003; serial annual payments through June 1, 2033; at rates from 2.0% to 4.125% with 3.98% average coupon; unsecured; proceeds used for various capital projects | 21,010,000 | - |
| Variable Rate Demand Educational Facilities Revenue Bonds, Series 2003B - Issued December 11, 2003; variable payments through June 1, 2029; variable interest rate, 1.05% as of June, 2004 with synthetic fixed rate of 3.746%; unsecured; proceeds used for various capital projects | 10,240,000 | - |
| | 73,811,555 | 70,416,781 |
| Less current portion | 1,767,470 | 1,015,225 |
| | \$ 72,044,085 | \$ 69,401,556 |

Principal payments on long-term debt are required to be made in each of the following fiscal years: \$1,767,470 in 2005; \$1,840,239 in 2006; \$1,968,570 in 2007; \$2,032,503 in 2008; \$2,092,082 in 2009 and \$64,110,691 in subsequent years thereafter.

The fair value of the College's long-term debt at June 30, 2004 was estimated to be approximately \$73,119,000 based upon rates available to the College for debt with similar terms and remaining maturities.

On July 8, 2003, the College refinanced the 2001A variable rate bond issue of \$21,450,000 and reissued the same amount as a fixed rate issue callable in 2013. This transaction was approved and directed by the Board of Trustees to reduce the interest rate risk associated with the variable rate structure. Also, in December 2003 the College refinanced the 1994 bonds by issuing the 2003B bonds with an additional \$5,000,000 for James Hall renovation.

NOTES TO FINANCIAL STATEMENTS

(8) CONTRIBUTIONS RECEIVABLE AND BEQUESTS IN PROBATE

| | June 30, 2004 Total | Due In | | | June 30, 2003 Total |
|---|---------------------------|---------------------|---------------------------|--------------------|---------------------------|
| | | One Year or Less | One Year to Five Years | Over Five Years | |
| Unconditional Promises for - | | | | | |
| Unrestricted | \$ 142,473 | \$ 76,655 | \$ 38,308 | \$ 27,510 | \$ 203,061 |
| Restricted | 104,652 | 20,102 | 54,550 | 30,000 | 110,000 |
| Buildings and equipment | 356,898 | 232,386 | 124,512 | - | 1,199,287 |
| Endowment | 2,258,729 | 690,269 | 769,460 | 799,000 | 3,500,175 |
| Reserve for unfulfilled promises | (160,000) | (60,000) | (60,000) | (40,000) | (250,000) |
| Total | <u>2,702,752</u> | <u>959,412</u> | <u>926,830</u> | <u>816,510</u> | <u>4,762,523</u> |
| Bequests in Probate | 5,388,856 | 5,042,856 | 346,000 | - | 1,562,805 |
| Charitable Lead Trusts | <u>77,916</u> | <u>38,958</u> | <u>38,958</u> | - | <u>158,057</u> |
| Total | <u>\$ 8,169,524</u> | <u>\$ 6,041,226</u> | <u>\$ 1,311,788</u> | <u>\$ 816,510</u> | <u>\$ 6,483,385</u> |
| Present Value of Estimated Future Cash Flows | <u>\$ 7,959,088</u> | <u>\$ 6,041,226</u> | <u>\$ 1,240,586</u> | <u>\$ 677,276</u> | <u>\$ 6,313,721</u> |

(9) COMMITMENTS AND CONTINGENCIES

During the normal course of business, the College is involved in various claims and lawsuits. In the opinion of management, the potential loss on all claims and lawsuits, net of insurance proceeds, will not be significant to the College's financial position, results of operations, or liquidity.

At June 30, 2004, the College was committed under various contracts with private equity investment managers to fund approximately \$17,200,000 capital calls for these investments. These capital calls will occur over the term of the respective agreements, which is generally a ten-year period. As these capital calls are made, funds will be reallocated from investments in fixed-income securities. These private equity investments are consistent with the target asset allocation guidelines for long-term investments as established by the College's Board of Trustees.

The College has purchase commitments relating to construction projects of approximately \$2,093,000 as of June 30, 2004.

NOTES TO FINANCIAL STATEMENTS

(10) NET ASSETS RELEASED FROM RESTRICTIONS

Donor-imposed restrictions expired on temporarily restricted net assets during the years ended June 30, as follows:

| | 2004 | 2003 |
|---|--------------|--------------|
| Purpose Restricted Contributions for - | | |
| Instruction | \$ 566,194 | \$ 435,737 |
| Public service | 681,815 | 685,077 |
| Academic support | 170,013 | 400,216 |
| Student services | 156,936 | 181,613 |
| Student aid | 1,670,014 | 1,544,074 |
| General and administrative | - | 1,479 |
| Development and alumni | 14,112 | 28,250 |
| | 3,259,084 | 3,276,446 |
| Time-Restricted Contributions - Amortization of Restricted Gifts to Acquire Long-Lived Assets | 901,962 | 845,575 |
| Total Net Assets Released from Restriction | \$ 4,161,046 | \$ 4,122,021 |
| Matured Annuity and Life Income Contracts - | | |
| Temporarily Restricted Agreements Reclassified to Tuition Replacement Funds in Unrestricted Net Assets | \$ 444,843 | \$ 611,815 |

(11) ELECTRIC AND WATER UTILITY REVENUE

The College owns and operates the electric and water utilities and provides these services to customers in the City of Berea. The College is a significant customer of both utilities. The utility revenues generated by College use are as follows:

| | 2004 | 2003 |
|--------------------|--------------|--------------|
| Electric and Water | \$ 1,398,137 | \$ 1,222,787 |

The above revenues and related expenses are eliminated in the statement of activities.

(12) FEDERAL TAX-EXEMPT STATUS

Berea College has a determination from the Internal Revenue Service that it is a not-for-profit organization exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code.