# BEREA COLLEGE

## Financial Statements

for the Year Ended June 30, 2005

**Board of Trustees**



**Officers**

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# HIGHLIGHTS

| | June 30, 2005 | June 30, 2004 |
|---|---|---|
| **OPERATING REVENUE** | $ 60,176,473 | $ 59,179,429 |
| **OPERATING EXPENSES** | $ 62,541,450 | $ 55,426,358 |
| **OPERATING REVENUE IN EXCESS OF (LESS THAN) EXPENSES FROM CONTINUING OPERATIONS** | $ (2,364,977) | $ 3,753,071 |
| **ADDITIONS TO PROPERTY, PLANT AND EQUIPMENT** | $ 7,592,032 | $ 14,128,513 |
| **LONG-TERM INVESTMENTS OF THE ENDOWMENT AND TUITION REPLACEMENT FUNDS** | | |
| Original gift value | $310,184,731 | $291,178,337 |
| Investments at market | $861,678,500 | $794,962,600 |
| Interest and dividends, net | $ 19,194,300 | $ 15,088,772 |
| Return | 2.4% | 2.2% |
| Market price increase | $ 64,563,137 | $100,426,969 |
| Return | 8.4% | 14.2% |
| Total return | $ 83,757,437 | $115,515,741 |
| Percent - time weighted | 10.8% | 16.4% |
| **CASH AND IN-KIND CONTRIBUTIONS** | | |
| Cash gifts | $ 10,087,615 | $ 9,974,728 |
| Bequests | 15,217,070 | 16,802,567 |
| Total cash gifts | 25,304,685 | 26,777,295 |
| Gifts-in-kind | 96,889 | 43,586 |
| Total | $ 25,401,574 | $ 26,820,881 |

# REPORT OF THE VICE PRESIDENT FOR FINANCE

August 2005

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

As another year has wound to a close, and as we have prepared these statements of the College's financial position, we are reminded of the tremendous responsibility we share as stewards of the College's financial resources. For 150 years, Berea College has served men and women, black and white from the Appalachian Region and beyond. Today, the College is a very diverse community. During the upcoming historic year, there will be many opportunities for celebration of the College's sesquicentennial. As we celebrate, let us also pause to reflect on the many challenges that the College has successfully faced over these many years, and be mindful of the challenges that will undoubtedly be faced in the future.

This summer, I had the opportunity to spend a few hours in the College Archives. You will notice the photos and artifacts reproduced and included with these financial statements are from the early history of Berea. As I reviewed several historical financial reports, I was reminded of the many trustees, faculty, staff and others coming before us—many of them serving the College for many years—whose dedication and service helped to guide and shape the College. We truly stand on their shoulders today as we continue their work and strive to maintain that the promise of Berea College will exist 150 years from now and be ever more vibrant and financially secure.

In order to help ensure that future students will have the opportunity of a Berea College learning experience, during 2004-05 a sustainable financial plan was developed and approved that includes an integrated consideration of the College's endowment and financial assets, people and program resources, and physical plant assets. Although the plan must be continuously monitored and adjusted accordingly, it will provide trustees and administrators with an excellent framework for financial planning now and into the future.

Given that the College's pooled long-term investments provide (through the endowment spending policy) nearly 77% of the funds needed for the annual operating budget, it is critically important that the endowment grow through market appreciation and the addition of new gifts. Through a well-diversified investment portfolio and positive equity markets, the total net return for the endowment was 10.8% for the fiscal year ending June 30, 2005. This represents a net market-price increase of more than $64 million. In addition, over $19 million was added to the endowment as a result of new gifts and matured planned giving instruments, resulting in an all-time high year-end market value of $861.7 million at June 30, 2005. For the year, $36.0 million was provided by the endowment spending policy in support of overall College operations.

The College's comprehensive capital campaign continues. As of June 30, 2005, the College had raised a total of $147.6 million through the comprehensive capital campaign. This campaign, which began in July 1999 and which was announced publicly in September 2003, is generating funds for strategic initiatives including technology, international study, sustainability, and other capital and programmatic needs. The campaign is on target and is scheduled to conclude on December 31, 2005. For the fiscal year just ended, the College experienced another outstanding fundraising year receiving a total of $25.4 million in gifts. Of this total, $4.0 million was designated for current operations and the remainder was designated for the endowment or for specific projects or purposes.

The renovation of James Residence Hall was completed during 2004-05. This renovation provides students with a much improved residential and learning environment. Also during the year, the College finalized the sale of certain Electric and Water Utility assets to the City of Berea. A portion of the proceeds from the sale are being used to fund the construction of a new campus heat plant. Another source of funding for the heat plant is a $9 million bond issue that will be completed in September 2005. The new heat plant is expected to be fully operational by August

2006 and construction of the campus hot and cold water pipeline distribution network is well underway. Moody's Investors Service has maintained its Aaa bond rating on all of the College's bonds.

**Financial Position**

The College maintains its strong financial position. As of June 30, 2005, *total net assets* (total assets less liabilities) of the College approximated $998.2 million for an increase of $74.6 million from the previous year. This change reflects an increase in the market value of long-term investments during the year from $838.3 million as of June 30, 2004, to $911.9 million as of June 30, 2005.

At June 30, 2005, *total assets* of Berea College were $1.1 billion. Of this amount, long-term investments (including endowment funds, annuity and life income funds and other funds) comprised $911.9 million; net property, plant and equipment, and bond defeasance escrow investments totaled $130.0 million; and current assets totaled $33.3 million. Contributions receivable and bequests in probate totaled $10.9 million; non-current prepaid expenses totaled $1.0 million; and student educational loans totaled approximately $2.0 million.

*Total liabilities* decreased by $3.0 million, primarily due to the $3.5 million principal payment of the 1993 bond issue as a result of exercising call provisions, and the payment of current maturities of long-term debt of $1.8 million. This decrease in total liabilities was partially offset by an increase in annuity and life-income payment liabilities, along with the liability associated with interest rate swaps on variable rate debt.

**Current Operations**

The 2004-05 fiscal year ended with a surplus from budgeted operations of over $138,000. This surplus was primarily due to less than budgeted faculty and staff salaries and less net controllable expenses, which were partially offset by a significant increase in natural gas prices. The 2005-06 budget includes an increase of 4.6% in endowment income that will provide funding for a 3.6% increase in the overall educational and general operating budget.

**Concluding Comments**

As you can see from the pages that follow, the College has enjoyed another financially successful year and its financial position remains very strong. During the year, several long-serving members of the Board of Trustees completed their years of service to the College. The fruits of their labor are evident as one looks at the overall excellent condition of the College today. We have said many times that the exceptional leadership of the Board of Trustees, along with the tremendous generosity of Berea's alumni and many friends, sustain the important Berea mission and ensure the promise of Berea College to future generations. We thank you again for your role in this important mission, whether as student, faculty, staff, alumni, trustee or friend.

Much of what happens at Berea College is truly inspiring. Together, we must all support and maintain this great opportunity to truly make a difference in the world through education and service. While we must always be mindful of the College's distinguished history over the last 150 years, we must continually seek to collegially discuss and debate our ideals, in quest of ways to always advance this great institution.

There will be many opportunities for reflection and celebration during this historic year at Berea College. We invite you to celebrate with us, and to visit soon.

Respectfully submitted,

Jeff Amburgey
Vice President for Finance

Deloitte.

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INDEPENDENT AUDITORS' REPORT

To the Board of Trustees
Berea College
Berea, Kentucky

We have audited the accompanying statements of financial position of Berea College (College) as of June 30, 2005 and 2004, 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 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 Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the College as of June 30, 2005 and 2004, the changes in its net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

September 8, 2005

# Berea College

## STATEMENTS OF FINANCIAL POSITION

| | June 30, 2005 | June 30, 2004 |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS** | | |
| Cash and cash equivalents | $ 19,575,461 | $ 15,437,784 |
| Other investments - absolute return fund | 6,742,765 | 6,438,516 |
| Accrued interest on investments | 3,682,781 | 3,122,039 |
| Accounts and notes receivable | 1,382,791 | 1,954,297 |
| Inventories | 1,857,042 | 2,266,210 |
| Prepaid expenses and other assets | 18,905 | 28,905 |
| Total current assets | 33,259,745 | 29,247,751 |
| **NON-CURRENT PREPAID EXPENSES AND OTHER ASSETS** | 965,461 | 2,210,400 |
| **CONTRIBUTIONS RECEIVABLE AND BEQUESTS IN PROBATE** | 10,946,675 | 7,959,088 |
| **LONG-TERM RECEIVABLES** | | |
| Institutional student loans | 1,666,564 | 1,536,865 |
| Federal student loans | 354,319 | 324,999 |
| Total long-term receivables | 2,020,883 | 1,861,864 |
| **LONG-TERM INVESTMENTS** | | |
| Donor-restricted endowment | 477,633,600 | 440,447,600 |
| Tuition replacement | 384,044,900 | 354,515,000 |
| Annuity and life income | 28,041,500 | 25,522,500 |
| Funds held in trust by others | 22,203,300 | 17,844,000 |
| Total long-term investments | 911,923,300 | 838,329,100 |
| **BOND DEFEASANCE ESCROW** | 8,409,474 | - |
| **BOND PROCEEDS FOR CAPITAL ADDITIONS** | - | 1,096,152 |
| **LONG-LIVED ASSETS HELD FOR SALE** | - | 17,089,750 |
| **NET PROPERTY, PLANT AND EQUIPMENT** | 121,595,925 | 119,730,433 |
| Total assets | $1,089,121,463 | $1,017,524,538 |

*See notes to financial statements.*

# Berea College

## STATEMENTS OF FINANCIAL POSITION

### LIABILITIES AND NET ASSETS

| | June 30, 2005 | June 30, 2004 |
|---|---|---|
| **CURRENT LIABILITIES** | | |
| Accounts payable | $ 4,859,890 | $ 4,493,085 |
| Accrued salaries and wages | 2,483,009 | 2,464,723 |
| Deposits and agency funds | 312,904 | 553,588 |
| Deferred income | 83,931 | 98,601 |
| Current maturities of long-term debt | 1,840,239 | 1,767,470 |
| Total current liabilities | 9,579,973 | 9,377,467 |
| **LONG-TERM LIABILITIES** | | |
| Annuity payment/deferred giving liability and other liabilities | 15,086,100 | 12,528,400 |
| Long-term debt | 66,268,846 | 72,044,085 |
| Total long-term liabilities | 81,354,946 | 84,572,485 |
| Total liabilities | 90,934,919 | 93,949,952 |
| **NET ASSETS** | | |
| Unrestricted - | | |
| For current operations | 86,116 | 82,899 |
| Designated for specific purposes | 33,291,486 | 24,705,081 |
| Invested in property, plant and equipment | 16,662,958 | 27,223,842 |
| Support of future operations from: | | |
| Contributions receivable and bequests in probate | 4,090,056 | 3,981,717 |
| Appreciation on endowment investments | 252,146,244 | 232,533,565 |
| Tuition replacement funds | 384,044,900 | 354,515,000 |
| Total unrestricted | 690,321,760 | 643,042,104 |
| Temporarily restricted - | | |
| Unexpended contributions restricted for operations | 5,927,824 | 4,948,118 |
| Unexpended contributions restricted for plant renewals and replacement | 1,607,446 | 1,522,702 |
| Annuity and life income contracts | 6,928,629 | 6,763,287 |
| Expended contributions for long-lived assets being amortized | 28,562,350 | 28,457,528 |
| Appreciation on endowment investments primarily to support various programs/services | 68,286,871 | 61,262,687 |
| Total temporarily restricted | 111,313,120 | 102,954,322 |
| Permanently restricted - | | |
| Loan funds | 3,324,892 | 3,154,970 |
| Annuity and life income contracts | 7,707,671 | 6,394,813 |
| Funds held in trust by others | 22,203,300 | 17,844,000 |
| Endowment investments | 163,315,801 | 150,184,377 |
| Total permanently restricted | 196,551,664 | 177,578,160 |
| Total net assets | 998,186,544 | 923,574,586 |
| Total liabilities and net assets | $1,089,121,463 | $1,017,524,538 |

*See notes to financial statements.*

## STATEMENTS OF ACTIVITIES

### Changes in Unrestricted Net Assets

| | Year Ended June 30, 2005 | 2004 |
|---|---|---|
| **OPERATING REVENUE** | | |
| Spendable return from long-term investments | $ 32,312,908 | $ 33,281,631 |
| Gifts and donations | 5,549,914 | 4,324,604 |
| Federal grants, primarily for student labor | 4,730,909 | 4,278,006 |
| Cost of education fees paid by federal and state scholarships | 2,260,638 | 2,500,000 |
| Fees paid by students | 1,071,613 | 1,005,301 |
| Other income | 3,742,820 | 3,521,447 |
| Residence halls and food service | 6,111,063 | 5,482,487 |
| Student industries and rentals | 2,943,911 | 3,361,490 |
| Net assets released from restrictions | 4,197,239 | 4,161,046 |
| Gross operating revenue | 62,921,015 | 61,916,012 |
| Less: Student aid | (2,744,542) | (2,736,583) |
| Net operating revenue | 60,176,473 | 59,179,429 |
| **OPERATING EXPENSES** | | |
| Program Services - | | |
| Instruction | 18,886,500 | 18,321,083 |
| Public service | 3,085,917 | 3,165,589 |
| Academic support | 6,633,880 | 5,934,172 |
| Student services | 7,219,059 | 7,214,504 |
| Residence halls and food service | 5,805,420 | 4,968,680 |
| Student industries and rentals | 4,228,100 | 3,981,578 |
| Total Program Services | 45,858,876 | 43,585,606 |
| Support Services, including fund raising expense of $2,739,200 in 2005 and $2,708,600 in 2004 | 11,515,213 | 10,737,649 |
| Interest expense | 5,167,361 | 1,103,103 |
| Total operating expenses | 62,541,450 | 55,426,358 |
| Operating revenue in excess of (less than) operating expenses from continuing operations | (2,364,977) | 3,753,071 |
| Gain on disposal of property, plant and equipment | 126,539 | 255,459 |
| Income from discontinued operations | 1,297,418 | 273,903 |
| **REVENUES DESIGNATED FOR LONG-TERM INVESTMENT** | | |
| Unrestricted bequests | 6,914,530 | 11,587,291 |
| Matured annuity and life income contracts | 611,137 | 444,843 |
| Investment return in excess of amounts designated for current operations | 40,695,009 | 67,063,018 |
| Total increase in revenues designated for long-term investment | 48,220,676 | 79,095,152 |
| Increase in unrestricted net assets | $ 47,279,656 | $ 83,377,585 |

*See notes to financial statements.*

## STATEMENTS OF ACTIVITIES

### Changes in Total Net Assets

| | Year Ended June 30, 2005 | 2004 |
|---|---|---|
| **UNRESTRICTED NET ASSETS** | | |
| Operating revenue in excess of (less than) operating expenses from continuing operations | $ (2,364,977) | $ 3,753,071 |
| Gain on sale of property, plant and equipment | 126,539 | 255,459 |
| Income from discontinued operations | 1,297,418 | 273,903 |
| Increase in revenues designated for long-term investment | 48,220,676 | 79,095,152 |
| Increase in unrestricted net assets | 47,279,656 | 83,377,585 |
| **TEMPORARILY RESTRICTED NET ASSETS** | | |
| Restricted gifts and donations | 2,233,516 | 1,855,087 |
| Restricted spendable return on endowment investments | 3,484,646 | 3,221,390 |
| Investment return in excess of (less than) amounts designated for current operations | 7,014,498 | 11,703,861 |
| Net adjustment of annuity payment and deferred giving liability | 434,514 | 55,839 |
| Reclassification of net assets released from restrictions | (4,197,239) | (4,161,046) |
| Reclassification of matured annuity and life income contracts to revenues designated for long-term investment | (611,137) | (444,843) |
| Increase in temporarily restricted net assets | 8,358,798 | 12,230,288 |
| **PERMANENTLY RESTRICTED NET ASSETS** | | |
| Gifts and donations | 13,691,201 | 10,699,267 |
| Restricted spendable return on endowment investments | 250,376 | 245,841 |
| Restricted capital gains on funds held in trust by others | 4,359,300 | 1,405,700 |
| Net adjustment of annuity payment and deferred giving liability | 672,627 | 350,046 |
| Increase in permanently restricted net assets | 18,973,504 | 12,700,854 |
| Total change in net assets | 74,611,958 | 108,308,727 |
| **NET ASSETS** | | |
| Beginning of year | 923,574,586 | 815,265,859 |
| End of year | $ 998,186,544 | $ 923,574,586 |

*See notes to financial statements.*

# STATEMENTS OF CASH FLOWS

| | Year Ended June 30, 2005 | Year Ended June 30, 2004 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Increase in net assets | $ 74,611,958 | $ 108,308,727 |
| Adjustments to reconcile change in net assets to net cash provided by operating activities - | | |
| Market price increase in long-term investments | (52,068,807) | (80,330,799) |
| Gifts and bequests for financing activities | (20,445,878) | (22,528,506) |
| Increase in contributions receivable and bequests in probate | (2,987,587) | (1,645,367) |
| Gift value of annuity contracts written | (1,457,230) | (1,067,671) |
| Depreciation | 5,273,848 | 5,736,886 |
| Gain on disposal of property, plant and equipment | (126,539) | (255,459) |
| Net adjustment of annuity payment liability and other long-term liabilities other than long-term debt | 409,759 | (241,885) |
| (Increase) decrease in non-current prepaid expenses and other assets | 1,244,939 | (1,166,051) |
| Increase in current assets other than cash and other investments | (2,022,958) | (968,709) |
| Increase in current liabilities other than current maturities of long-term debt | 324,472 | 158,025 |
| Restricted spendable return on endowment funds | (250,376) | (245,841) |
| Net cash provided by operating activities | 2,505,601 | 5,753,350 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchases of securities held for long-term investment | (1,191,746,274) | (660,083,438) |
| Proceeds from sales and maturities of investments | 1,162,907,559 | 642,952,771 |
| Purchase of other investments - absolute return fund | - | (3,000,000) |
| Purchase of property, plant and equipment | (7,592,032) | (14,128,513) |
| Proceeds from sale of property, plant and equipment other than electric and water utility assets | 300,692 | 282,046 |
| Proceeds from sale of electric and water utility assets | 19,317,195 | - |
| Long-term student loans | (519,217) | (438,046) |
| Long-term student loan repayments | 360,198 | 354,412 |
| Gain on annuity and life income investments | 2,235,220 | 2,275,145 |
| Net cash used by investing activities | (14,736,659) | (31,785,623) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Gifts and bequests received for - | | |
| Long-term investment | 19,484,785 | 21,710,475 |
| Property, plant and equipment | 955,412 | 794,058 |
| Student loans | 5,681 | 23,973 |
| Proceeds received on annuity and life income contracts | 3,248,483 | 1,653,094 |
| Contractual payments on annuity and life income contracts | (1,873,532) | (1,816,883) |
| Endowment return restricted for long-term investments | 250,376 | 245,841 |
| Repayment of indebtedness | (5,702,470) | (28,295,226) |
| Long-term debt issued | - | 31,690,000 |
| Net cash provided by financing activities | 16,368,735 | 26,005,332 |
| Net change in cash and cash equivalents | 4,137,677 | (26,941) |
| Cash and cash equivalents, beginning of year | 15,437,784 | 15,464,725 |
| Cash and cash equivalents, end of year | $ 19,575,461 | $ 15,437,784 |

*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 2005 and 2004 was:

| | 2005 | 2004 |
|---|---|---|
| Educational and general properties | $ 4,910,046 | $ 4,545,654 |
| Student industry equipment | 333,072 | 451,287 |
| Utility plant and equipment | 30,730 | 739,945 |
| | $ 5,273,848 | $ 5,736,886 |

### 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 $3,030,136 in 2005 and $3,063,030 in 2004.

### 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 items such as depreciation and plant operation expenses have been allocated among the programs and supporting services benefited.

### Reclassification

Certain reclassifications have been made to the 2004 financial statements to conform to the 2005 presentation.

# NOTES TO FINANCIAL STATEMENTS

(2) LONG-TERM INVESTMENTS

| | June 30, 2005 | June 30, 2004 |
|---|---|---|
| **Endowment and Tuition Replacement:** | | |
| Pooled Investments - | | |
| Domestic common stocks | $348,023,900 | $326,826,400 |
| International common stocks | 175,090,800 | 152,755,600 |
| Corporate notes and bonds | 81,907,000 | 74,856,900 |
| U. S. Government securities | 48,550,000 | 52,708,500 |
| Foreign bonds | 1,772,400 | 1,066,700 |
| Structured notes | 59,841,400 | 54,366,700 |
| Private equity, venture capital and other | 58,758,200 | 57,293,100 |
| Hedge funds | 41,150,500 | 31,482,900 |
| Real estate | 10,446,400 | 16,852,500 |
| Short-term investments and cash | 32,172,600 | 22,822,300 |
| Total | 857,713,200 | 791,031,600 |
| Non Pooled Investments - | | |
| Domestic common stocks | 304,800 | 262,100 |
| Real estate | 2,772,900 | 2,772,900 |
| Short-term investments and cash | 887,600 | 896,000 |
| Total | 3,965,300 | 3,931,000 |
| Total endowment and tuition replacement | 861,678,500 | 794,962,600 |
| **Annuity and Life Income:** | | |
| Pooled Annuity Investments - | | |
| Domestic common stocks | 8,802,600 | 8,579,100 |
| International common stocks | 1,825,900 | 1,324,300 |
| Corporate notes and bonds | 3,792,700 | 3,162,200 |
| Short-term investments and cash | 190,300 | 392,700 |
| Total | 14,611,500 | 13,458,300 |
| Separately Invested Trusts - | | |
| Common stocks | 6,187,700 | 6,008,400 |
| International common stocks | 1,100,200 | 591,400 |
| Corporate notes and bonds | 4,545,900 | 3,833,400 |
| U. S. Government securities | 450,600 | 455,800 |
| Real estate | 525,000 | 525,000 |
| Short-term investments and cash | 620,600 | 650,200 |
| Total | 13,430,000 | 12,064,200 |
| Total annuity and life income | 28,041,500 | 25,522,500 |
| **Funds Held in Trust by Others,** where Berea College receives all or a stipulated percent of income | 22,203,300 | 17,844,000 |
| Total long-term investments | $911,923,300 | $838,329,100 |

# NOTES TO FINANCIAL STATEMENTS

(2) <u>LONG-TERM INVESTMENTS</u> (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 2005 and 2004, spendable return under the formula amounted to $35,889,191 and $36,824,780, respectively. In 2005, actual cash income earned on pooled investments, net of $1,746,751 for investment management and custodial fees, amounted to $19,035,560, or $16,853,631 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 $158,740 in 2005 and $95,351 in 2004, while the market value of these investments of $3,965,300 at June 30, 2005 and $3,931,000 at June 30, 2004 increased by $29,300 in 2005 and $13,500 in 2004. Net additions to non-pooled endowment investments during 2005 amounted to $5,000 and no transfers were made to pooled investments.

Dividend and interest income of $19,194,300 and $15,260,042 reported net of external investment manager fees of $1,746,751 and $1,603,948 is included in the statements of activities for the years ended June 30, 2005 and 2004, respectively.

(2) LONG-TERM INVESTMENTS (continued)

During 2005, the unit value of pooled investments changed as follows:

| | 2004-05 | | | | 2003-04 |
|---|---|---|---|---|---|
| | Market Value | Number of Units | Value Per Unit | Total Return Percent Net of Fees | Market Value |
| Beginning Balance | $791,031,600 | 611,817.1 | $ 1,292.92 | | $704,846,400 |
| Gift annuities transferred from pool | - | - | | | (12,949,400) |
| Balance after transfer | 791,031,600 | 611,817.1 | | | 691,897,000 |
| Market price change | 64,533,837 | - | 105.18 | 8.4% | 100,413,469 |
| Net income earned | 19,035,560 | - | 31.11 | 2.4% | 15,164,691 |
| Spendable return | (35,889,191) | - | (58.66) | - | (36,824,780) |
| | 47,680,206 | | 77.63 | 10.8% | 78,753,380 |
| Additions | 19,001,394 | 13,999.8 | - | | 20,381,220 |
| Ending Balance | $857,713,200 | 625,816.9 | $ 1,370.55 | | $791,031,600 |

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

| | 2005 | 2004 |
|---|---|---|
| Pooled Investments - | | |
| Cash income, net | $ 19,035,560 | $ 15,164,691 |
| Market price increase | 64,533,837 | 100,413,469 |
| Non-Pooled Investments - | | |
| Cash income | 158,740 | 95,351 |
| Market price increase | 29,300 | 13,500 |
| Total Return | 83,757,437 | 115,687,011 |
| Less: Charitable Gift Annuity Contracts | | |
| Cash income | - | (171,270) |
| Endowment return | 83,757,437 | 115,515,741 |
| Distributed to - | | |
| Unrestricted Net Assets | | |
| Spendable return | 32,312,908 | 33,281,631 |
| Long-term investments | 40,695,009 | 67,063,018 |
| Temporarily Restricted Net Assets | | |
| Spendable return | 3,484,646 | 3,221,390 |
| Investment return in excess of amounts designated for current operations | 7,014,498 | 11,703,861 |
| Permanently Restricted | | |
| Restricted earnings | 250,376 | 245,841 |
| Total | $ 83,757,437 | $ 115,515,741 |

## 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 negative $1,516,900 at June 30, 2005 and positive $1,060,900 at June 30, 2004 and is included in the annuity payment/deferred giving liability and other liabilities for 2005 and in non-current prepaid expenses and other assets in the statements of financial position in 2004. The change in market value of the interest rate swaps has been reflected in the statements of activities as an increase in interest expense of $2,577,800 in 2005 and as a reduction of interest expense of $1,060,900 in 2004.

(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 $1,688,921 in 2005 and $1,724,546 in 2004.

(5) PROPERTY, PLANT AND EQUIPMENT

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

| Property, Plant and Equipment | 2005 | 2004 |
|---|---|---|
| Educational property, plant and equipment | $ 146,692,047 | $ 138,886,644 |
| Electric and water utility plant | - | 2,454,444 |
| Student industry plant and equipment | 7,886,778 | 8,094,268 |
| Rental property | 2,704,762 | 2,897,954 |
| Forest and farms | 1,230,970 | 717,179 |
| Collections and works of art | 3,101,031 | 3,101,031 |
| Less accumulated depreciation | (40,019,663) | (36,421,087) |
| | $ 121,595,925 | $ 119,730,433 |

(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 provided for the sale of certain Electric and Water Utility assets to the City of Berea at book value. The sale closed on January 26, 2005 and the College received $19,317,195 for the property, plant and equipment and net working capital. No gain or loss was realized on the sale. Net operating results of the Electric and Water Utilities are reflected in discontinued operations in the statements of activities. The College now purchases electricity and water from the City of Berea.

# NOTES TO FINANCIAL STATEMENTS

(7) LONG-TERM DEBT

| | June 30, 2005 | | June 30, 2004 |
|---|---|---|---|
| KDFA Loan Agreement - Issued June 1986; due in monthly installments to June 2011; variable interest rate, 3.65% as of June 2005; unsecured; proceeds used for various capital projects | $ 829,085 | | $ 936,555 |
| 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 |
| 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 | 2,255,000 | | 2,375,000 |
| 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 | 1,925,000 | * | 2,325,000 |
| 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 | 6,710,000 | | 7,055,000 |
| 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 | 2,165,000 | | 2,260,000 |

# NOTES TO FINANCIAL STATEMENTS

(7) LONG-TERM DEBT (continued)

| | June 30, 2005 | June 30, 2004 |
|---|---|---|
| Variable Rate Demand Educational Facilities Revenue Bonds, Series 2002A - Issued August 29, 2002; variable payments through June 1, 2032; variable interest rate, 2.25% as of June, 2005; with synthetic fixed rate of 3.45%; unsecured; proceeds used for various capital projects | $ 17,675,000 | $ 18,110,000 |
| 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 | 20,560,000 | 21,010,000 |
| Variable Rate Demand Educational Facilities Revenue Bonds, Series 2003B - Issued December 11, 2003; variable payments ghrough June 1, 2029; variable interest rate, 2.25% as of June, 2005 with synthetic fixed rate of 3.746%; unsecured; proceeds used for varous capital projects | 9,990,000 | 10,240,000 |
| | 68,109,085 | 73,811,555 |
| Less current portion | 1,840,239 | 1,767,470 |
| | $ 66,268,846 | $ 72,044,085 |

Principal payments on long-term debt are required to be made in each of the following fiscal years: $1,840,239 in 2006; $1,968,570 in 2007; $2,032,503 in 2008; $2,092,082 in 2009; $1,657,353 in 2010 and $58,518,338 in subsequent years thereafter.

* On January 26, 2005 the sale of certain electric and water utility assets to the City of Berea was completed. A bond defeasance escrow was established in the amount of $12,131,145 from a portion of the sale proceeds by investing the cash in State and Local Government Securities (SLGS) to defease the interest and principal on the bonds. The series 1993 bond issue in the amount of $3,500,000 was called on May 1, 2005 @ $101. The series 1997 bond issue in the amount of $6,000,000 will be called on June 1, 2007 @ $102. The series 1998 bond issue in the outstanding amount of $1,925,000 is not callable and will be paid based on the scheduled serial maturities.

The fair value of the College's long-term debt that has not been defeased at June 30, 2005 was estimated to be approximately $60,407,000 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 the James Hall renovation.

## NOTES TO FINANCIAL STATEMENTS

(8) CONTRIBUTIONS RECEIVABLE AND BEQUESTS IN PROBATE

| | June 30, 2005 Total | Due In One Year or Less | Due In One Year to Five Years | Due In Over Five Years | June 30, 2004 Total |
|---|---|---|---|---|---|
| Unconditional Promises for - | | | | | |
| Unrestricted | $ 90,009 | $ 48,873 | $ 40,136 | $ 1,000 | $ 142,473 |
| Restricted | 205,375 | 127,860 | 62,515 | 15,000 | 104,652 |
| Buildings and equipment | 546,787 | 472,075 | 74,712 | - | 356,898 |
| Endowment | 1,910,877 | 558,283 | 630,594 | 722,000 | 2,258,729 |
| Reserve for unfulfilled promises | (150,000) | (50,000) | (60,000) | (40,000) | (160,000) |
| Total | 2,603,048 | 1,157,091 | 747,957 | 698,000 | 2,702,752 |
| Bequests in Probate | 8,549,193 | 6,223,193 | 2,326,000 | - | 5,388,856 |
| Charitable Lead Trusts | 38,958 | 38,958 | - | - | 77,916 |
| Total | $ 11,191,199 | $ 7,419,242 | $ 3,073,957 | $ 698,000 | $ 8,169,524 |
| Present Value of Estimated Future Cash Flows | $ 10,946,675 | $ 7,419,242 | $ 2,945,942 | $ 581,491 | $ 7,959,088 |

(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.

The College receives grants and contracts from certain federal, state, and local agencies to fund various activities. The costs, both direct and indirect, that have been charged to the grants or contracts are subject to examination and approval by the granting agency. It is the opinion of the College's administration that any disallowance or adjustment of such costs would not have a material effect on the financial statements.

At June 30, 2005, the College was committed under various contracts with private equity investment managers to fund approximately $36,974,000 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 $13,775,000 as of June 30, 2005.

## 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:

| | 2005 | 2004 |
|---|---|---|
| Purpose Restricted Contributions for - | | |
| Instruction | $ 514,014 | $ 566,194 |
| Public service | 596,757 | 681,815 |
| Academic support | 147,423 | 170,013 |
| Student services | 121,798 | 156,936 |
| Student aid | 1,783,989 | 1,670,014 |
| Development and alumni | - | 14,112 |
| | 3,163,981 | 3,259,084 |
| Time-Restricted Contributions - Amortization of Restricted Gifts to Acquire Long-Lived Assets | 1,033,258 | 901,962 |
| Total Net Assets Released from Restriction | $ 4,197,239 | $ 4,161,046 |
| Matured Annuity and Life Income Contracts - | | |
| Temporarily Restricted Agreements Reclassified to Tuition Replacement Funds in Unrestricted Net Assets | $ 611,137 | $ 444,843 |

(11) ELECTRIC AND WATER UTILITY REVENUE

On January 26, 2005, the College sold certain assets of the electric and water utilities to the City of Berea. Until that time, the College owned and operated the electric and water utilities and provided 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:

| | 2005 | 2004 |
|---|---|---|
| Electric and Water | $ 894,885 | $ 1,398,137 |

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.