

Consolidated Financial Statements and Report of Independent Certified Public Accountants

Abilene Christian University

May 31, 2006 and 2005

Report of Independent Certified Public Accountants

Board of Trustees
Abilene Christian University

We have audited the accompanying consolidated statements of financial position of Abilene Christian University (the University) and subsidiaries as of May 31, 2006 and 2005, and the related consolidated statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America as established by the Auditing Standards Board of the American Institute of Certified Public Accountants and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Abilene Christian University and subsidiaries as of May 31, 2006 and 2005, and the changes in their net assets and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note R to the consolidated financial statements, in fiscal 2006, the University adopted Financial Accounting Standards Board (FASB) Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143."

In accordance with *Government Auditing Standards*, we have also issued our report dated August 4, 2006 on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



Dallas, Texas
August 4, 2006

1717 Main Street
Suite 1500
Dallas, TX 75201
T 214.561.2300
F 214.561.2370
W www.grantthornton.com

Abilene Christian University

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

May 31,

ASSETS	2006	2005
Cash and cash equivalents	\$ 1,976,304	\$ 1,228,407
Accounts and notes receivable, net	8,442,208	6,487,959
Contributions receivable, net	4,760,201	3,334,518
Inventories	2,805,032	3,532,361
Prepaid expenses and other assets	1,480,656	1,150,435
Investments	210,153,115	180,190,568
Charitable trusts and annuities	45,018,697	43,939,202
Property and equipment, net of accumulated depreciation and amortization	<u>105,013,993</u>	<u>94,849,695</u>
Total assets	<u>\$379,650,206</u>	<u>\$334,713,145</u>
LIABILITIES AND NET ASSETS		
Accounts payable	\$ 1,482,025	\$ 1,574,184
Accrued interest payable	322,556	353,738
Accrued salaries and benefit expenses	11,387,268	11,674,822
Advance on lines of credit	6,000,000	7,789,867
Deposits and other liabilities	17,130,749	4,135,060
Reserve for charitable trusts and annuities	28,981,011	27,689,044
Long-term obligations	<u>48,841,229</u>	<u>46,866,854</u>
Total liabilities	<u>114,144,838</u>	<u>100,083,569</u>
Commitments and contingencies		
Net assets		
Unrestricted	125,357,348	102,906,053
Temporarily restricted	7,789,314	4,749,977
Permanently restricted	<u>132,358,706</u>	<u>126,973,546</u>
Total net assets	<u>265,505,368</u>	<u>234,629,576</u>
Total liabilities and net assets	<u>\$379,650,206</u>	<u>\$334,713,145</u>

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

Abilene Christian University
CONSOLIDATED STATEMENTS OF ACTIVITIES
Year ended May 31, 2006

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Operating:				
Revenues, gains and other support				
Tuition and fees	\$ 62,900,553	\$ -	\$ -	\$ 62,900,553
Less - scholarship allowances	(17,081,093)	-	-	(17,081,093)
Net tuition and fees	45,819,460	-	-	45,819,460
Auxiliary enterprises sales and services	17,377,410	-	-	17,377,410
Private gifts and grants	1,138,054	2,612,841	-	3,750,895
Endowment support	10,652,513	-	-	10,652,513
Government grants and contracts	2,236,763	-	-	2,236,763
Other revenue	5,734,385	93,835	-	5,828,220
Net assets released from restrictions	2,711,771	(2,711,771)	-	-
Total revenues, gains, and other support	<u>85,670,356</u>	<u>(5,095)</u>	<u>-</u>	<u>85,665,261</u>
Expenses				
Operating expenses:				
Instruction and research	25,586,664	-	-	25,586,664
Academic support	6,583,055	-	-	6,583,055
Student services	7,731,783	-	-	7,731,783
Public services	2,556,861	-	-	2,556,861
Expenses of auxiliary enterprises	21,819,432	-	-	21,819,432
Fundraising	2,473,103	-	-	2,473,103
Management and general	16,999,488	-	-	16,999,488
Total operating expenses	<u>83,750,386</u>	<u>-</u>	<u>-</u>	<u>83,750,386</u>
Increase (decrease) in net assets from operating activities	1,919,970	(5,095)	-	1,914,875
Non-operating:				
Contributions for endowment, plant, and other	1,046,408	8,160,862	4,756,609	13,963,879
Investment return, net of amount designated for operations	23,288,895	253,709	132,800	23,675,404
Other revenues	46,595	2,487	-	49,082
Net assets released from endowment, plant and other	5,606,733	(5,606,733)	-	-
Changes in value of split-interest agreements	108,552	234,107	495,751	838,410
Endowment, plant, and other	(1,005,596)	-	-	(1,005,596)
Increase in net assets from non-operating activities	<u>29,091,587</u>	<u>3,044,432</u>	<u>5,385,160</u>	<u>37,521,179</u>
Total change in net assets before cumulative effect of change in accounting principle	31,011,557	3,039,337	5,385,160	39,436,054
Cumulative effect of change in accounting principle (Note R)	(8,560,262)	-	-	(8,560,262)
Total change in net assets	<u>22,451,295</u>	<u>3,039,337</u>	<u>5,385,160</u>	<u>30,875,792</u>
Net assets at beginning of year	<u>102,906,053</u>	<u>4,749,977</u>	<u>126,973,546</u>	<u>234,629,576</u>
Net assets at end of year	<u>\$125,357,348</u>	<u>\$ 7,789,314</u>	<u>\$132,358,706</u>	<u>\$265,505,368</u>

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

Abilene Christian University

CONSOLIDATED STATEMENTS OF ACTIVITIES

Year ended May 31, 2005

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Operating:				
Revenues, gains and other support				
Tuition and fees	\$ 59,387,685	\$ -	\$ -	\$ 59,387,685
Less - scholarship allowances	(15,372,934)	-	-	(15,372,934)
Net tuition and fees	44,014,751	-	-	44,014,751
Auxiliary enterprises sales and services	16,687,547	-	-	16,687,547
Private gifts and grants	1,191,988	1,480,802	-	2,672,790
Endowment support	10,262,055	-	-	10,262,055
Government grants and contracts	2,230,474	-	-	2,230,474
Other revenue	4,046,338	90,572	-	4,136,910
Net assets released from restrictions	4,254,939	(4,254,939)	-	-
Total revenues, gains, and other support	<u>82,688,092</u>	<u>(2,683,565)</u>	<u>-</u>	<u>80,004,527</u>
Expenses				
Operating expenses:				
Instruction and research	23,662,231	-	-	23,662,231
Academic support	6,367,841	-	-	6,367,841
Student services	7,256,157	-	-	7,256,157
Public services	2,559,336	-	-	2,559,336
Expenses of auxiliary enterprises	20,933,239	-	-	20,933,239
Fundraising	2,529,967	-	-	2,529,967
Management and general	18,003,588	-	-	18,003,588
Total operating expenses	<u>81,312,359</u>	<u>-</u>	<u>-</u>	<u>81,312,359</u>
Increase (decrease) in net assets from operating activities	1,375,733	(2,683,565)	-	(1,307,832)
Non-operating revenues, expenses, and other changes:				
Contributions for endowment, plant, and other	42,822	1,643,716	7,040,390	8,726,928
Investment return, net of amount designated for operations	9,991,773	115,137	186,746	10,293,656
Other revenues	2,928	2,981	-	5,909
Net assets released from endowment, plant, and other	3,154,502	(2,800,569)	(353,933)	-
Changes in value of split-interest agreements	(5,253)	(238,324)	1,391,585	1,148,008
Endowment, plant, and other	<u>(977,106)</u>	<u>-</u>	<u>-</u>	<u>(977,106)</u>
Increase (decrease) in net assets from non-operating activities	<u>12,209,666</u>	<u>(1,277,059)</u>	<u>8,264,788</u>	<u>19,197,395</u>
Total change in net assets	13,585,399	(3,960,624)	8,264,788	17,889,563
Net assets at beginning of year	<u>89,320,654</u>	<u>8,710,601</u>	<u>118,708,758</u>	<u>216,740,013</u>
Net assets at end of year	<u>\$102,906,053</u>	<u>\$ 4,749,977</u>	<u>\$126,973,546</u>	<u>\$234,629,576</u>

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

Abilene Christian University

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended May 31,

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities		
Change in net assets	\$ 30,875,792	\$ 17,889,563
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Cumulative effect of change in accounting principle	8,560,262	-
Depreciation and amortization	5,784,141	5,593,151
Depletion	700,000	560,000
Net change in agency accounts	120,466	(104,606)
Noncash contributions	(5,232,660)	(2,319,677)
Contributions restricted for long-term investment	(3,159,965)	(6,523,852)
Interest and dividends restricted for reinvestment	(531,362)	(535,304)
Changes in value of split-interest agreements	(838,410)	(1,148,008)
Net unrealized and realized gains on investments	(24,482,474)	(11,870,674)
(Increase) decrease in:		
Accounts and notes receivable	(1,786,948)	(147,725)
Contributions receivable	(1,425,683)	3,465,924
Inventories	727,329	(339,403)
Prepaid expenses	(330,221)	(75,523)
Increase (decrease) in:		
Accounts payable	(92,159)	916,276
Accrued expenses	(318,736)	556,479
Deposits and other liabilities	<u>5,341,474</u>	<u>(513,199)</u>
Net cash provided by operating activities	13,910,846	5,403,422
Cash flows from investing activities		
Purchase of property and equipment	(17,140,746)	(8,623,864)
Proceeds from sale of equipment	44,740	41,385
Disbursement of loans to students, faculty and others	(653,829)	(422,319)
Repayment of loans from students, faculty and others	580,200	761,160
Proceeds from sale of investments	27,925,119	32,370,466
Purchase of investments	<u>(26,064,221)</u>	<u>(36,105,555)</u>
Net cash used in investing activities	(15,308,737)	(11,978,727)

Abilene Christian University

CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

Years ended May 31,

	<u>2006</u>	<u>2005</u>
Cash flows from financing activities		
Proceeds from contributions restricted for:		
Investment in endowment	\$ 2,932,589	\$ 5,587,752
Investment in plant	<u>227,376</u>	<u>936,100</u>
	3,159,965	6,523,852
Other financing activities		
Interest and dividends restricted for reinvestment	531,362	535,304
Proceeds of split-interest obligations	500	1,000
Payment of split-interest obligations	(1,730,547)	(1,723,728)
Proceeds from lines of credit	40,414,091	36,284,448
Payment of lines of credit	(42,203,958)	(33,174,402)
Proceeds from long-term obligations	16,110,590	1,270,000
Payment of long-term obligations	<u>(14,136,215)</u>	<u>(6,719,590)</u>
	<u>(1,014,177)</u>	<u>(3,526,968)</u>
Net cash provided by financing activities	<u>2,145,788</u>	<u>2,996,884</u>
Net increase (decrease) in cash and cash equivalents	747,897	(3,578,421)
Cash and cash equivalents at beginning of year	<u>1,228,407</u>	<u>4,806,828</u>
Cash and cash equivalents at end of year	\$ <u>1,976,304</u>	\$ <u>1,228,407</u>
Non-cash transactions:		
Improvements capitalized and recorded in accounts payable	\$ 446,228	\$ -
Non-cash contributions	5,232,660	2,319,677
Increase in value of property and equipment to recognize the associated conditional retirement obligations (see Note R)	1,508,034	-
Other required disclosures:		
Interest paid	\$ 2,903,007	\$ 2,378,506

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

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

May 31, 2006 and 2005

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidation

The accompanying consolidated financial statements include the financial position, activities, and cash flows of Abilene Christian University (the "University"), a not for profit institution of higher education, and its subsidiaries, the ACU Foundation (the "Foundation"), the SCRM Press and ACU in Oxford (UK). All significant interrelated accounts and transactions have been eliminated in the accompanying consolidated financial statements. The University has majority voting and economic interests in the ACU Foundation and ACU in Oxford (UK).

Basis of Accounting

The consolidated financial statements of the University have been prepared on the accrual basis of accounting. The focus of these financial statements is to present the University as a whole and to present balances and transactions according to the existence or absence of donor-imposed restrictions. This has been accomplished by classification of transactions into three classes of net assets - unrestricted, temporarily restricted or permanently restricted.

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

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

Permanently restricted net assets - Net assets subject to donor-imposed stipulations that they be maintained permanently by the University. 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.

Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Expirations of temporary restrictions on net assets (i.e., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications between the applicable classes of net assets.

Contributions, including unconditional promises to give, are recognized as revenues in the period received. Conditional promises to give are not recognized until they become unconditional, that is when the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair value. Contributions received with donor-imposed restrictions that are met in the same year as received are reported as revenues of the temporarily restricted net asset class, and a reclassification to unrestricted net assets is made to reflect the expiration of such restrictions. Contributions to be received after one year are discounted at an appropriate discount rate commensurate with the risks involved. Amortization of discount is recorded as additional contribution revenue in accordance with donor-imposed restrictions, if any, on the contributions. An allowance for uncollectible contributions receivable is provided based upon management's judgment including such factors as prior collection history, type of contribution and nature of fund-raising activity.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Contributions of land, building and equipment without donor stipulations concerning the use of such long-lived assets are reported as revenues of the unrestricted net asset class. Contributions of cash or other assets to be used to acquire land, building and equipment with such donor stipulations are reported as revenues of the temporarily restricted net asset class; the restrictions are considered to be released at the time of acquisition of such long-lived assets. Purchased investments are recorded at cost at acquisition. Investments received by gift are recorded at the market value of the asset as of the date of donation. Non-marketable securities are valued on the date of donation using independent appraisals and are adjusted for subsequent perceived permanent declines in value that are considered other than temporary. Readily marketable investments (investments readily marketable on national exchanges) are adjusted for changes in market value.

Income and realized and unrealized gains on investments of endowments and similar funds are reported as increases in permanently restricted net assets if the terms of the gift require that they be added to the principal of a permanent endowment fund; as increases in temporarily restricted net assets if the terms of the gift impose restrictions on the use of the income; as increases in unrestricted net assets in all other cases. Investment income and realized and unrealized gains on endowment funds, whose restrictions are met in the same reporting period, are reported as revenues of the unrestricted net asset class. Investment losses on endowments and similar funds are reported as decreases in unrestricted net assets.

Endowment earnings used in or available for current operations under the University's current spending policy are recorded in the consolidated statement of activities as endowment support. Endowment earnings in excess of the University's endowment spending policy are recorded as investment return, net of amounts designated for operations, in the consolidated statements of activities.

From time to time the University enters into derivative transactions, via mutual funds, as part of its overall investment asset allocation. Derivatives, excluding interest rate hedge derivatives discussed below, are used as part of this asset allocation strategy are recorded at fair value with realized and unrealized gains and losses reflected in the consolidated statements of activities. These derivatives are included in the investment portfolio to reduce market volatility. Interest rate hedge derivatives on the University's debt portfolio are described in Note Q.

Investments in the physical plant are recorded at cost. Significant renovations to existing buildings are capitalized, while maintenance and repairs are expensed when incurred. Equipment purchases under \$1,000 are not capitalized. Provision for depreciation is made on a straight-line basis over the estimated useful life of the asset. Currently, these estimated useful lives are as follows:

Buildings and building improvements	15-55 years
Improvements other than buildings	15 years
Equipment	5-10 years

When disposition is made of plant assets, the cost and accumulated depreciation are removed from the accounting records, and the resulting gain or loss is recognized in the consolidated statements of activities.

Inventories are valued at amounts, which, in the aggregate, approximate the lower of cost or market on the first-in, first-out basis.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Tax Status

The University is a tax-exempt institution and is not a "private foundation" under the Tax Reform Act of 1969; accordingly, no provision for taxes has been made in the consolidated financial statements. The Foundation has also been accorded recognition as exempt from income tax under Sections 501(c)(3) and 509(a)(3) of the Internal Revenue Code of 1986.

Cash and Cash Equivalents

For the purposes of the consolidated statements of cash flows, the University considers all cash and other highly liquid investments with original maturities of three months or less to be cash equivalents. The University places its cash and cash equivalents with high quality financial institutions, which at times may exceed federally insured limits. The University has not experienced any losses on such accounts.

Accounts and Notes Receivable

Receivables are recorded at the contractual amounts owed by students and others adjusted for unamortized discounts, unearned income, undisbursed funds, deferred loan fees, and an allowance for losses. Interest income is recorded on the accrual basis in accordance with the terms of receivables.

The estimated allowances for uncollectible accounts and notes receivable are accounted for using the reserve method. Under this method, allowances are maintained at a level which, in the judgment of management, is adequate to meet the present and potential risks of uncollectibility of the accounts and notes receivable. Management's judgment is based on a variety of factors, which include experience related to charge-offs and recoveries, and scrutiny of individual accounts and notes receivable. Amounts deemed by management to be uncollectible are charged to expenses. Recoveries on receivables previously charged-off are credited to expenses. Provisions for receivable losses are charged to expense and credited to the allowance for uncollectible accounts and notes receivable. At May 31, 2006 and 2005, the allowance for uncollectibles was \$592,249.

Advertising Costs

Advertising costs are expensed as incurred and were \$343,284 and \$294,636 for 2006 and 2005, respectively.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Reclassifications

Certain reclassifications have been made to the 2005 consolidated financial statements to conform to the 2006 presentation. These reclassifications include a change in the presentation and classification of the consolidated statements of activities to reflect a measure of operations.

NOTE B - CONTRIBUTIONS RECEIVABLE

Contributions receivable are as follows at May 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Unconditional promises expected to be collected in:		
Less than one year	\$ 4,514,689	\$ 1,694,547
One year to five years	2,927,333	3,676,112
Over five years	<u>105,000</u>	<u>-</u>
	7,547,022	5,370,659
Less discount for net present value	(1,167,230)	(203,914)
Less allowance for uncollectible contributions receivable	<u>(1,619,591)</u>	<u>(1,832,227)</u>
	<u>\$ 4,760,201</u>	<u>\$ 3,334,518</u>

The contributions are to be utilized for the following purposes:

	<u>2006</u>	<u>2005</u>
Operations and scholarships	\$1,595,241	\$3,286,039
Acquisition of land, building and equipment	<u>3,164,960</u>	<u>48,479</u>
	<u>\$4,760,201</u>	<u>\$3,334,518</u>

Contributions receivable as of May 31, 2006 and 2005 have been discounted using rates ranging from 1.24% to 5.28%.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE C - INVESTMENTS

Investments consist of the following at May 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Mutual funds and investment partnerships managed by third parties, at market	\$191,772,786	\$159,185,572
Notes receivable	430,101	267,653
Stocks and bonds	2,984,087	7,911,856
Real estate and mineral interests, net of depletion	12,385,255	9,398,938
Outside managed	2,007,333	2,837,021
Other investments	<u>573,553</u>	<u>589,528</u>
	<u>\$210,153,115</u>	<u>\$180,190,568</u>

Outside managed investments primarily include several outside managed trusts comprised of stocks, bonds, real estate, mineral interests and other assets.

As of May 31, 2006 and 2005 the cost of investments was \$176,059,843 and \$164,123,519, respectively. The carrying values of investments include gross unrealized gains of \$36,875,979 and \$18,927,906 and gross unrealized losses of \$2,782,707 and \$2,860,857 as of May 31, 2006 and 2005, respectively.

Components of income related to investments for the years ended May 31, 2006 and 2005 is as follows:

	<u>2006</u>	<u>2005</u>
Interest income	\$ 281,919	\$ 519,596
Dividend income	1,452,163	1,520,921
Mineral income	7,733,871	6,390,012
Ranch income	363,410	361,084
Rental income	86,371	50,850
Net realized and unrealized gains	24,482,474	11,724,192
Other	<u>(72,291)</u>	<u>(10,944)</u>
Total investment income	<u>\$34,327,917</u>	<u>\$20,555,711</u>

The University maintains an investment pool for use by its endowment funds (excluding assets held in trust by the Foundation). The University's policy allows the pool to invest in domestic equities, international equities, fixed income securities, marketable alternative investments, real estate, mineral interests and other investments deemed suitable. The mutual funds and investment partnerships are invested by several professional third-party managers with different investment styles to diversify risk and maximize returns. For the year ended May 31, 2006, the spendable income allocated was \$6,081,798. The total return for the pool, including interest, dividends and net realized and unrealized investment appreciation, was approximately 16.4% for the year ended May 31, 2006. For the year ended May 31, 2005, the spendable income allocated was \$5,334,385. The total return for the pool, including interest, dividends and net realized and unrealized investment appreciation, was approximately 9.9% for the year ended May 31, 2005.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE C - INVESTMENTS - Continued

As of May 31, 2006 and 2005, the investment pool was composed of the following:

	<u>2006</u>	<u>2005</u>
Mutual funds and investment partnerships managed by third parties, at market	\$153,556,333	\$125,200,907
Notes receivable	167,578	177,365
Donated stocks	395,049	76,832
Cash and cash equivalents	2,963,311	245,119
Other	<u>-</u>	<u>6,210</u>
	<u>\$157,082,271</u>	<u>\$125,706,433</u>

NOTE D - PROPERTY AND EQUIPMENT

At May 31, 2006 and 2005, property and equipment consisted of the following:

	<u>2006</u>	<u>2005</u>
Buildings	\$105,852,390	\$ 96,214,048
Improvements to land and building	25,922,874	21,302,277
Equipment	<u>23,809,014</u>	<u>20,504,073</u>
	155,584,278	138,020,398
Less accumulated depreciation and amortization	<u>(56,014,112)</u>	<u>(48,994,978)</u>
	99,570,166	89,025,420
Construction in progress	2,539,128	2,919,576
Land	<u>2,904,699</u>	<u>2,904,699</u>
	<u>\$105,013,993</u>	<u>\$ 94,849,695</u>

Depreciation and amortization expense for the years ending May 31, 2006 and 2005, was \$5,784,141 and \$5,593,151, respectively.

Construction in progress as of May 31, 2006 consists primarily of the Education Building (formerly Burford Hall) renovation which is scheduled for occupancy in August 2006. When completed the cost of this project will be approximately \$3,000,000.

During fiscal year 2006, \$112,669 of interest was capitalized.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE E - LONG-TERM OBLIGATIONS PAYABLE

Long-term obligations as of May 31, 2006 and 2005, were as follows:

	<u>2006</u>	<u>2005</u>
1995 - Higher Education Revenue Refunding and Improvement Bonds; payable in annual installments; maturing in fiscal year 2012; interest rates ranging from 4.6% to 6.25%; secured by revenues.	\$ -	\$12,885,000
1998 - Higher Education Revenue Refunding and Improvement Bonds; payable in annual installments; maturing in fiscal year 2019; interest rate of 4.75%; secured by revenues subordinate to the series 1995 debt.	9,000,000	9,220,000
2001 - Higher Education Revenue Improvement Bonds; payable in semi-annual installments; maturing in fiscal year 2021; interest rate of 5.0%; secured by revenues.	8,085,568	8,440,542
2002 - Higher Education Revenue Bonds; variable interest rate; all principal due at maturity on July 17, 2006; secured by revenues.	6,000,000	6,000,000
2003 - Higher Education Revenue Bonds; payable in semi-annual installments; maturing in fiscal year 2024; variable interest rate; secured by revenues.	8,667,573	8,995,812
2005 - Tax-exempt Lease; payable in semi-annual installments; maturing in fiscal year 2010; interest rate of 3.59%; secured by leased technology equipment.	1,028,248	1,270,000
2005 - Higher Education Revenue Bonds; payable in semi-annual installments; maturing in fiscal year 2026; variable interest rate; secured by revenues.	6,700,000	-
2005 B - Higher Education Revenue Bonds; payable in semi-annual installments; maturing in fiscal year 2026; variable interest rate; secured by revenues.	1,979,250	-
2006 - Higher Education Revenue Bonds; payable in semi-annual installments; maturing in fiscal year 2026; variable interest rate; secured by revenues.	7,380,590	-
Miscellaneous notes payable	<u>-</u>	<u>55,500</u>
	<u>\$48,841,229</u>	<u>\$46,866,854</u>

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE E - LONG-TERM OBLIGATIONS PAYABLE - Continued

On June 1, 2005, the University issued \$6,700,000 in revenue bonds. The bonds bear interest based on 65% of the 30-day LIBOR rate plus 1.00%. The bonds are payable in semi-annual installments of principal and interest beginning October 2006 through April 2026. On December 1, 2005, the University issued \$2,030,000 in revenue bonds. The bonds bear interest based on 65% of the 30-day LIBOR rate plus 1.00%. The bonds are payable in semi-annual installments of principal and interest through October 2025.

On January 31, 2006, the University issued \$7,380,590 in revenue bonds. Proceeds from the bonds in the amount of \$6,297,596 were used to refund all of the outstanding Series 1995 debt, proceeds in the amount of \$1,015,000 were used to fund the renovation of the Education Building (formerly the Burford Music Building), and remaining funds were used to pay closing and legal costs of the issue. In the process of refunding the 1995 debt, \$2,500,138 was released from an escrow account established as part of the 1998 debt issuance, which had previously refunded \$4,505,000 of the Series 1995 debt. All funds released from the escrow account were used to retire the 1995 debt. A call premium of \$169,100 was paid to the holders of the 1995 debt.

Variable rate Series 2002, 2003, 2005, and 2005B interest rates are based on 65% of the 30-day LIBOR rate plus 1.00% (4.32% and 3.03% for the years ending May 31, 2006 and 2005, respectively). Series 2006 variable rate interest is based on 65% of the 30-day LIBOR rate plus 0.55%, 3.87% as of May 31, 2006.

A schedule of future fiscal year principal payments of long-term debt follows:

2007	\$ 7,676,104
2008	2,778,488
2009	3,437,776
2010	3,164,057
2011	3,021,729
Thereafter	<u>28,763,075</u>
	<u>\$48,841,229</u>

Total interest expense for long term debt for the years ended May 31, 2006 and 2005, was \$2,605,319 and \$2,156,798, respectively.

NOTE F - LINES OF CREDIT

At May 31, 2006, the University had two line of credit agreements to provide operating cash flows. These lines have been established to maximize endowment earnings and facilitate cash management. These agreements have maximum available lines of credit totaling \$7,000,000 with First Financial Bank, Abilene and \$6,000,000 with Bank of America, N.A. At May 31, 2006, there were no amounts outstanding on the First Financial Bank line. \$6,000,000 was outstanding on the Bank of America line. At May 31, 2005, \$1,789,867 and \$6,000,000 were outstanding on the First Financial Bank line and the Bank of America, respectively. The lines are unsecured with interest payable at prime minus 1.0% or LIBOR plus 1.75%, respectively.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE F - LINES OF CREDIT - Continued

Total interest expense for commercial lines of credit for the years ended May 31, 2006 and 2005, was \$390,609 and \$244,071, respectively.

NOTE G - RESTRICTIONS AND LIMITATIONS ON NET ASSET BALANCES

Permanently restricted net assets at May 31, 2006 and 2005 are listed below according to the purpose for which the income for these items is to be used:

	<u>2006</u>	<u>2005</u>
Student loans	\$ 1,370,809	\$ 1,216,754
Scholarships	75,268,020	72,767,579
Instruction, research, and divisional support	31,321,360	27,420,066
General operations	5,325,772	5,157,305
Pledges receivable	<u>1,225,991</u>	<u>2,940,385</u>
	114,511,952	109,502,089
Life income, student loan funds and other accounts	<u>17,846,754</u>	<u>17,471,457</u>
	<u>\$132,358,706</u>	<u>\$126,973,546</u>

Temporarily restricted net assets consist of the following at May 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Gifts and other unexpended revenues and gains available for:		
Student loans	\$ 168,367	\$ 174,421
Scholarships	5,082	10,236
Instruction, research, and divisional support	1,616,747	2,050,790
General operations	146,928	97,584
Acquisition of buildings and equipment	<u>3,807,738</u>	<u>694,341</u>
	5,744,862	3,027,372
Life income, student loan funds and other accounts	<u>2,044,452</u>	<u>1,722,605</u>
	<u>\$7,789,314</u>	<u>\$4,749,977</u>

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE H - NET ASSETS RELEASED FROM RESTRICTIONS

The sources of net assets released from temporary and permanent donor restrictions by incurring expenses satisfying the restricted purposes or by occurrence of events specified by the donors were as follows for the years ended May 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Scholarships	\$ 30,674	\$1,228,968
Instruction, research and divisional support	3,390,702	3,025,971
Life income, student loan funds and other accounts	558,768	631,973
Acquisition or donation of land, buildings and equipment	<u>4,338,360</u>	<u>2,522,529</u>
	<u>\$8,318,504</u>	<u>\$7,409,441</u>

NOTE I - ENDOWMENT FUNDS

As of May 31, 2006 and 2005, the University's net assets from endowment accounts were composed of the following:

	<u>2006</u>	<u>2005</u>
Permanently restricted endowment:		
Managed by the University or the Foundation	\$112,245,889	\$106,667,168
Managed by third party trusts	<u>2,007,333</u>	<u>2,837,021</u>
Total permanently restricted endowment	114,253,222	109,504,189
Temporarily restricted endowment:		
Managed by the University	1,937,124	1,717,921
Unrestricted endowment	<u>91,248,313</u>	<u>63,815,134</u>
Total endowment accounts	<u>\$207,438,659</u>	<u>\$175,037,244</u>

While readily marketable investments (investments readily marketable on national exchanges) are adjusted for changes in market value, real estate and mineral interests are carried at the estimated market value on the date the asset was gifted to or purchased into the endowment (adjusted for depletion). Based on internal evaluations, management believes the market value of the underlying assets to be substantially greater than the carrying value. If adjusted based on management's estimates, the total market value of the endowment as of May 31, 2006 and 2005 would be \$228,761,113 and \$189,786,539, respectively.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE J - CHARITABLE TRUSTS AND ANNUITIES

The University is party to a number of charitable trusts and annuities, the majority of which the University, or the University through its affiliate Foundation, is the trustee. Assets under charitable trusts and annuities consist of the following at May 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
University and Foundation as trustee		
Charitable trusts	\$42,585,776	\$41,329,371
Charitable gift annuities	<u>736,030</u>	<u>843,671</u>
	43,321,806	42,173,042
Third-party trustee	<u>1,696,891</u>	<u>1,766,160</u>
	<u>\$45,018,697</u>	<u>\$43,939,202</u>

For charitable trusts and annuities for which the University is trustee, contributions are recorded at fair value in the year of the agreement and are reflected as charitable trusts and annuities in the accompanying consolidated financial statements. For the years ending May 31, 2006 and 2005, \$61,161 and \$517,825, respectively, was recorded as contribution revenue related to these types of agreements. The total payments to annuitants and income beneficiaries during the years ended May 31, 2006 and 2005, were \$1,418,410 and \$1,481,960, respectively. In addition to the recording of the asset, a liability is recorded representing the discounted future cash flows expected to be paid to the specified beneficiary designated by the donor. The estimated liability of future cash flows is based upon the life expectancy of the donor, the current market value of the trust, a 7% expected future rate of return, and a 6% discount rate. Investment income, payments to beneficiaries and adjustments to the liability are reflected as changes in value of split-interest agreements in the consolidated statements of activities. The estimated liability of the future cash flows, as of May 31, 2006 and 2005, was \$28,981,011 and \$27,689,044, respectively.

For charitable trusts for which the University is not the trustee, contributions are recognized in the year the University becomes aware of the existence of the agreement and are valued at the discounted present value of expected future cash flows. The expected future cash flows have been discounted at a rate of 6% over the life expectancy of the parties involved and calculated based upon the current market value of the trust's assets and other factors stipulated in the agreements. The present value of the expected future cash flows has been reflected as a component of charitable trusts and annuities in the consolidated statements of financial position. The change in estimated present value is reflected as a change in value of split-interest agreements in the consolidated statements of activities.

NOTE K - RETIREMENT PLAN

The University has two defined contribution retirement plans, a 401(a) and 401(k) covering substantially all full and part-time personnel. The University contributes 4% of the employee's salary as a match to the employee's contribution of 2% in the 401(a). In addition, employees are required to contribute 2% of salary to participate in the 401(k) plan for which the University will contribute up to 4% of the employee's salary. University contributions under both plans totaled \$1,980,968 and \$2,208,066, respectively, for the years ended May 31, 2006 and 2005.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE L - POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

In addition to the University's defined contribution pension plan, the University sponsors a defined benefit health care plan that provides post-retirement medical benefits to currently retired employees and current full-time employees who have worked 10 years and attained age 55 while in service with the University as of May 31, 1995.

The following presents the plan's funded status as of May 31:

	<u>2006</u>	<u>2005</u>
Accumulated postretirement benefit obligation	\$(4,851,500)	\$(4,851,500)
Plan assets at fair value	<u>-</u>	<u>-</u>
Funded status	<u>\$(4,851,500)</u>	<u>\$(4,851,500)</u>
Accrued postretirement benefit cost	<u>\$(4,530,062)</u>	<u>\$(4,714,400)</u>
Annual benefit costs for the year ended May 31:		
Net periodic postretirement benefit cost	<u>\$ 254,100</u>	<u>\$ 254,100</u>
Employer contributions	\$ 190,700	\$ 190,700
Plan participant contributions	<u>-</u>	<u>-</u>
Benefits paid	<u>\$ 190,700</u>	<u>\$ 190,700</u>

The accrued postretirement benefit cost is recorded in accrued salaries and benefit expenses on the accompanying consolidated statements of financial position.

The weighted average annual assumed rate of increase in the per capita cost of covered medical benefits is 10% as of May 31, 2006 and is assumed to decrease gradually to 5.0% after six years and remain at that level thereafter. The weighted average discount rate used in determining the accumulated post-retirement benefit obligation was 5% at May 31, 2005 (last available actuarial calculation).

The weighted average annual assumed rate of increase in the per capita cost of covered medical benefits was 11% as of May 31, 2005 and was assumed to decrease gradually to 5.0% after seven years and remain at that level thereafter. The weighted average discount rate used in determining the accumulated post-retirement benefit obligation was 5% at May 31, 2005.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE L - POSTRETIREMENT BENEFITS OTHER THAN PENSIONS - Continued

The University expects to contribute \$469,000 to the post-retirement benefit plan in fiscal year 2007. Benefits expected to be paid over the next five years and thereafter are as follows:

2007	\$ 469,000
2008	478,600
2009	459,500
2010	444,500
2011	439,500
2012-2016	1,853,300

NOTE M - HEALTH INSURANCE

The University maintains a partially self-funded health insurance plan with insured specific and aggregate stop-loss coverage, administered by a third party administrator. The administrator acts as the University's agent in making benefit payments on the University's behalf. The total reserve for outstanding health claims was \$250,000 and \$254,000 at May 31, 2006 and 2005, respectively, and is recorded in accrued salaries and benefit expenses in the accompanying consolidated statements of financial position. The reserve will fund any health claims incurred but not paid or reported as of the end of the fiscal year.

NOTE N - COMMITMENTS AND CONTINGENCIES

The University leases facilities to support its study abroad programs under noncancellable operating agreements through 2020. Rent expense for 2006 and 2005 was \$592,604 and \$603,397, respectively. Future minimum rentals under the noncancellable leases as of May 31, 2006 are as follows:

Year ending	
<u>May 31,</u>	
2007	\$126,210
2008	31,680
2009	31,680
2010	31,680
2011	31,680
Thereafter	<u>334,224</u>
	<u>\$587,154</u>

In the normal course of operations, the University is named as a defendant in lawsuits and is subject to periodic examinations by regulatory agencies. After consultation with legal counsel, management is of the opinion that liabilities, if any, arising from such litigation and examinations would not have a material effect on the University's financial position, results of operations, or cash flows.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE O - SIGNIFICANT CONCENTRATIONS OF CREDIT RISK

The University grants credit in the form of accounts and notes receivable to students and others, a substantial portion of which are enrolled at the University. The University does not require collateral for the extension of credit with the exception of notes made to facilitate real estate sales, in which case, the collateral is typically the real estate being sold. Management periodically monitors credit risk through the evaluation of the account's status and ability to repay.

NOTE P - FAIR VALUE OF FINANCIAL INSTRUMENTS

In fiscal year 1996, the University adopted Statement of Financial Accounting Standards No. 107, "Disclosures about Fair Value of Financial Instruments", which requires entities to disclose the estimated fair value of its financial instrument assets and liabilities. Many of the University's financial instruments, however, lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction. It is also the University's general practice and intent to hold its financial instruments to maturity and not to engage in trading or sales activities with the exception of investments.

Estimated fair values have been determined by the University using the most relevant available data. The estimated fair values and recorded book balances at May 31, 2006 and 2005, are as follows:

Financial instruments actively traded in a secondary market have been valued using quoted available market prices.

	2006		2005	
	Recorded balance	Estimated fair value	Recorded balance	Estimated fair value
Financial assets				
Cash and cash equivalents	\$ 1,976,304	\$ 1,976,304	\$ 1,228,407	\$ 1,228,407
Contributions receivable	4,760,201	4,760,201	3,334,518	3,334,518
Stocks and bonds	2,984,087	2,984,087	7,911,856	7,911,856
Mutual funds	<u>191,772,786</u>	<u>191,772,786</u>	<u>159,185,572</u>	<u>159,185,572</u>
Total financial assets	<u>\$201,493,378</u>	<u>\$201,493,378</u>	<u>\$171,660,353</u>	<u>\$171,660,353</u>
Financial liabilities:				
Advance on lines of credit	\$ 6,000,000	\$ 6,000,000	\$ 7,789,867	\$ 7,789,867
Long-term obligations payable	<u>48,841,229</u>	<u>49,610,950</u>	<u>46,866,854</u>	<u>46,915,540</u>
Total financial liabilities	<u>\$ 54,841,229</u>	<u>\$ 55,610,950</u>	<u>\$ 54,656,721</u>	<u>\$ 54,705,407</u>

Changes in assumptions or estimation methodologies may have a material effect on these estimated fair values. The University's remaining assets and liabilities, which are not considered financial instruments have not been valued differently than has been customary with historical cost accounting.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE P - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

The University has determined that it is not practicable to estimate the fair value of notes receivable, donated stocks and bonds, and other investments and their related effective interest rates and maturity because there is no readily tradable market for such assets and the cost of developing a valuation model to estimate the fair value or obtaining an independent valuation of those financial instruments would exceed the benefit derived. The carrying amount of such assets at May 31, 2006 and 2005, are as follows:

	<u>2006</u>	<u>2005</u>
Notes receivable - student accounts	\$ 3,676,870	\$ 3,693,603
Investments:		
Notes receivable - other	430,101	267,653
Other investments	14,966,141	12,825,487

NOTE Q - DERIVATIVE INSTRUMENTS

The University entered into three interest rate swap agreements during fiscal year 2005. The Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires that the University disclose these swaps as fair value hedges. The primary reason for swapping from a variable to fixed rate is to stabilize the university's operating budget vis-à-vis interest expense.

Management has completed variable to fixed rate swaps on three debt issues: 1) Series 2003 has been swapped to a fixed rate of 4.59%, 2) Series 2005 has been swapped to a fixed rate of 4.59%, and 3) Series 2006 has been swapped to a fixed rate of 3.29% until September 1, 2011.

Management has identified the following benefits of using swap agreements to accomplish the above objectives:

1. Lower fixed rate is available using a swap than by refunding at a fixed rate.
2. Less paperwork and due diligence is involved in executing a swap than in a refunding. A swap is an agreement separate from the debt, but mimicking the debt repayment structure.
3. A swap does not affect the University's bank qualified debt limit of \$10 million per calendar year. This has allowed the University to issue additional debt for new construction and new network technology at the same time it restructures the variable rate debt.
4. The University can purchase the right to cancel the swap at predefined points.

Risks of using the proposed interest rate swaps:

1. Credit risk - risk that the counterparty will not fulfill its obligation on the swap contract.
2. Basis risk - mismatch between the interest rate received from the swap contract and the interest actually owed on the debt.
3. Opportunity cost - if the floating rate that the University can pay on the debt averages below the fixed rate the University pays on the swap, then the University has the opportunity cost associated with locking in the higher interest rate.

Abilene Christian University

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

May 31, 2006 and 2005

NOTE Q - DERIVATIVE INSTRUMENTS - Continued

The effectiveness of the swaps is judged by comparing the interest rates of the swaps with the interest rates on the underlying debt. The swap terms should identically match the critical terms of the floating rate debt, and thus would be expected to perfectly offset the hedged cash flows of the debt. Management believes the swaps are effective as of May 31, 2006 and, thus, no gain or loss relating to the swaps is reflected in the consolidated statements of activities.

NOTE R - CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE

Financial Accounting Standards Board Interpretation Number 47 (FIN 47), issued in March 2005, clarifies how entities should estimate future expenses necessary to comply with legal, regulatory, or contractual asset retirement activity as required by Statement of Financial Accounting Standards 143 (SFAS 143), "Accounting for Asset Retirement Obligations." The University adopted FIN 47 effective May 31, 2006 and has identified two categories of asset retirement obligations (ARO), related to various campus facilities, that must be reported: asbestos abatement and Americans with Disabilities Act (ADA) facility modifications. Both categories are appropriately managed by the University in accordance with current laws and regulations. However, it is possible that at some future date, renovations, demolition, or construction could occur that would require direct remediation of the University's AROs.

As a result of adopting FIN 47, the University recorded AROs totaling \$10,701,641 and increased the net value of its recorded assets by \$1,508,034 to recognize the associated conditional retirement obligations of removing the asbestos and complying with ADA. The University used an expected cash flow approach to measure these obligations. The cumulative effect of initial adoption of this interpretation was \$8,560,262.

The pro forma effects of retroactively applying FIN 47 at May 31, 2005 and 2004 are as follows:

	2005			2004		
	Per Financial Statements	FIN 47 Change	Pro Forma	Per Financial Statements	FIN 47 Change	Pro Forma
Change in net assets	\$ 17,889,563	\$ (8,560,262)	\$ 9,329,301	\$ 21,603,554	\$(7,926,917)	\$ 13,676,637
Net assets	234,629,576	(8,560,262)	226,069,314	216,740,013	(7,926,917)	208,813,096
Liabilities	100,083,569	10,124,542	110,208,111	100,013,255	9,547,443	109,560,698

NOTE S - SUBSEQUENT EVENTS

On July 17, 2006, the University issued \$6,000,000 in taxable debt for the purpose of refunding the remaining Series 2002 debt that matured on that date. The new note matures on April 1, 2026 and has a variable interest rate of the 30-day LIBOR rate plus 0.65%. Principal and interest are amortized over the life of the debt and are payable semiannually.