



WAKE FOREST UNIVERSITY

OMB Circular A-133 Reports

Year ended June 30, 2006

EIN #1 – 56-053-2138-A1

WAKE FOREST UNIVERSITY

OMB Circular A-133 Reports

Table of Contents

	Page
Basic Financial Statements – Year ended June 30, 2006 With Independent Auditors’ Report Thereon	1
Schedule of Expenditures of Federal and State Awards – Year ended June 30, 2006	27
Notes to Schedule of Expenditures of Federal and State Awards	31
Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	33
Report on Compliance with Requirements Applicable to Each Major Program and on Internal Control over Compliance in Accordance with OMB Circular A-133	34
Schedule of Findings and Questioned Costs	36



KPMG LLP
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Independent Auditors' Report

The Board of Trustees
Wake Forest University:

We have audited the accompanying consolidated statement of financial position of Wake Forest University as of June 30, 2006, and the related consolidated statements of activities and cash flows for the year then ended. These consolidated financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The prior year summarized comparative information has been derived from the University's 2005 financial statements and in our report dated September 9, 2005, we expressed an unqualified opinion on those financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides 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 Wake Forest University as of June 30, 2006, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 31, 2006 on our consideration of Wake Forest University's internal control over financial reporting and 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 testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included in the statements of financial position, activities and cash flows and the accompanying notes related to the College of Arts and Sciences, Schools of Law, Management, and Divinity, the Reynolda House, Inc. and Wake Forest University Health Sciences (collectively the University) is presented for purposes of additional analysis of the financial statements rather than to present the financial position, changes in net assets and cash flows of the individual entities. Such supplementary information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The accompanying schedule of expenditures of federal and state awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

As discussed in note 1(s), Wake Forest University adopted FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, during the year ended June 30, 2006.

KPMG LLP

October 31, 2006

WAKE FOREST UNIVERSITY
Consolidated Statement of Financial Position
June 30, 2006
(with comparative financial information as of June 30, 2005)
(Dollars in thousands)

Assets	Supplementary Information			2006	2005
	Reynolda Campus	WFUHS	Reynolda House		
Cash and cash equivalents	\$ 26,210	11,112	573	37,895	20,533
Accounts receivable, net	4,490	42,673	11	47,174	46,346
Clinic receivables, net	—	45,049	—	45,049	48,795
Grants receivable	1,577	7,069	113	8,759	12,078
Contributions receivable, net	37,945	5,338	84	43,367	48,264
Notes receivable, net	19,912	1,135	—	21,047	20,889
Investments	564,847	571,998	34,573	1,171,418	1,035,366
Investments in real estate	26,710	69,906	—	96,616	28,196
Land, buildings, and equipment, less accumulated depreciation	228,396	288,042	23,945	540,383	562,929
Other assets	5,393	12,968	96	18,457	15,527
Total assets	\$ 915,480	1,055,290	59,395	2,030,165	1,838,923
Liabilities and Net Assets					
Liabilities:					
Accounts payable and accruals	\$ 11,277	73,878	2,346	87,501	84,555
Other liabilities and deferrals	36,943	69,185	—	106,128	87,379
Annuities payable	22,656	5,168	—	27,824	26,306
Notes payable	6,468	78,488	—	84,956	46,887
Bonds payable	75,970	193,150	—	269,120	275,745
Postretirement benefits	8,607	2,288	—	10,895	8,728
Government grants refundable	10,656	654	—	11,310	11,629
Total liabilities	172,577	422,811	2,346	597,734	541,229
Net assets:					
Unrestricted undesignated	243,188	370,278	29,644	643,110	581,923
Net investment in plant	145,958	86,310	23,945	256,213	240,297
Total unrestricted	389,146	456,588	53,589	899,323	822,220
Temporarily restricted	187,575	67,660	1,130	256,365	216,218
Permanently restricted	166,182	108,231	2,330	276,743	259,256
Total net assets	742,903	632,479	57,049	1,432,431	1,297,694
Total liabilities and net assets	\$ 915,480	1,055,290	59,395	2,030,165	1,838,923

See accompanying notes to consolidated financial statements.

WAKE FOREST UNIVERSITY
Consolidated Statement of Activities
Year ended June 30, 2006
(with summarized financial information for the year ended June 30, 2005)
(Dollars in thousands)

	2006			Total	2005 Total
	Unrestricted	Temporarily restricted	Permanently restricted		
Revenues, gains, and other support:					
Educational and general:					
Student tuition and fees	\$ 182,757	—	—	182,757	169,202
Scholarship allowance	(53,802)	—	—	(53,802)	(51,053)
Net student tuition and fees	128,955	—	—	128,955	118,149
Federal grants and contracts	141,211	—	—	141,211	143,075
State grants and contracts	14,318	—	—	14,318	13,780
Private gifts, grants, and contracts	48,905	21,913	12,620	83,438	74,649
Dividends, interest, and rents	14,673	7,550	270	22,493	18,754
Interest on short-term investments and other income	6,040	172	390	6,602	3,693
Net realized and unrealized appreciation on investments	74,016	46,001	4,011	124,028	77,151
Organized activities relating to educational departments	3,803	403	60	4,266	3,701
Clinic services	329,791	—	—	329,791	328,563
Other sources	78,394	648	—	79,042	67,385
Total educational and general	840,106	76,687	17,351	934,144	848,900
Sales and services of auxiliary enterprises	76,352	4,655	1,012	82,019	74,977
Total revenues and gains	916,458	81,342	18,363	1,016,163	923,877
Net assets released from restrictions	40,368	(40,368)	—	—	—
Total revenues, gains, and other support	956,826	40,974	18,363	1,016,163	923,877
Expenses and losses:					
Educational and general:					
Instruction, departmental research, and clinical	530,411	—	—	530,411	504,605
Sponsored research, training, and other programs	154,278	—	—	154,278	157,992
Organized activities	2,154	—	—	2,154	2,393
Academic support	20,496	—	—	20,496	19,549
Libraries	14,993	—	—	14,993	14,829
Student services	15,794	—	—	15,794	13,991
Institutional support	80,096	—	—	80,096	67,898
Total educational and general	818,222	—	—	818,222	781,257
Auxiliary enterprises	60,881	—	—	60,881	59,002
Actuarial (gain) loss on annuity obligations	—	(145)	1,410	1,265	4,572
Unrealized (gain) loss on interest rate swap	(10,030)	—	—	(10,030)	7,021
Other	614	972	(534)	1,052	1,157
Total expenses and losses	869,687	827	876	871,390	853,009
Cumulative effect of changes in accounting principles	(10,036)	—	—	(10,036)	—
Increase in net assets	77,103	40,147	17,487	134,737	70,868
Net assets at beginning of year	822,220	216,218	259,256	1,297,694	1,226,826
Net assets at end of year	\$ 899,323	256,365	276,743	1,432,431	1,297,694

See accompanying notes to consolidated financial statements.

WAKE FOREST UNIVERSITY

Statement of Activities

College of Arts and Sciences, Schools of Law, Management, and Divinity
(Supplementary Information)

Year ended June 30, 2006

(Dollars in thousands)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Revenues, gains, and other support:				
Educational and general:				
Student tuition and fees	\$ 158,610	—	—	158,610
Scholarship allowance	(44,444)	—	—	(44,444)
Net student tuition and fees	114,166	—	—	114,166
Federal grants and contracts	6,447	—	—	6,447
State grants and contracts	1,399	—	—	1,399
Private gifts, grants, and contracts	12,609	4,249	8,211	25,069
Dividends, interest, and rents	4,959	5,757	270	10,986
Interest on short-term investments and other income	2,584	30	252	2,866
Net realized and unrealized appreciation				
on investments	27,352	32,839	1,011	61,202
Organized activities relating to educational department:	3,803	403	60	4,266
Clinic services	—	—	—	—
Other sources	2,071	647	—	2,718
Total educational and general	175,390	43,925	9,804	229,119
Sales and services of auxiliary enterprises	75,368	4,655	1,012	81,035
Total revenues and gains	250,758	48,580	10,816	310,154
Net assets released from restrictions	18,358	(18,358)	—	—
Total revenues, gains, and other support	269,116	30,222	10,816	310,154
Expenses and losses:				
Educational and general:				
Instruction, departmental research, and clinical	101,349	—	—	101,349
Sponsored research, training, and other programs	—	—	—	—
Organized activities	2,154	—	—	2,154
Academic support	8,218	—	—	8,218
Libraries	10,443	—	—	10,443
Student services	14,046	—	—	14,046
Institutional support	38,645	—	—	38,645
Total educational and general	174,855	—	—	174,855
Auxiliary enterprises	59,915	—	—	59,915
Actuarial (gain) loss on annuity obligations	—	(145)	456	311
Unrealized (gain) loss on interest rate swap	(1,739)	—	—	(1,739)
Other	1,077	1,029	(404)	1,702
Total expenses and losses	234,108	884	52	235,044
Cumulative effect of changes in accounting principles	(8,666)	—	—	(8,666)
Increase in net assets	26,342	29,338	10,764	66,444
Net assets at beginning of year	362,804	158,237	155,418	676,459
Net assets at end of year	\$ 389,146	187,575	166,182	742,903

See accompanying notes to consolidated financial statements.

WAKE FOREST UNIVERSITY
Statement of Activities
Wake Forest University Health Sciences
(Supplementary Information)
Year ended June 30, 2006
(Dollars in thousands)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Revenues, gains, and other support:				
Educational and general:				
Student tuition and fees	\$ 24,147	—	—	24,147
Scholarship allowance	(9,358)	—	—	(9,358)
Net student tuition and fees	14,789	—	—	14,789
Federal grants and contracts	134,764	—	—	134,764
State grants and contracts	12,919	—	—	12,919
Private gifts, grants, and contracts	35,548	17,297	4,409	57,254
Dividends, interest, and rents	9,213	1,740	—	10,953
Interest on short-term investments and other income	3,426	128	138	3,692
Net realized and unrealized appreciation on investments	40,667	12,520	3,000	56,187
Organized activities relating to educational department:	—	—	—	—
Clinic services	329,791	—	—	329,791
Other sources	76,062	—	—	76,062
Total educational and general	657,179	31,685	7,547	696,411
Sales and services of auxiliary enterprises	984	—	—	984
Total revenues and gains	658,163	31,685	7,547	697,395
Net assets released from restrictions	21,420	(21,420)	—	—
Total revenues, gains, and other support	679,583	10,265	7,547	697,395
Expenses and losses:				
Educational and general:				
Instruction, departmental research, and clinical	429,062	—	—	429,062
Sponsored research, training, and other programs	154,278	—	—	154,278
Organized activities	—	—	—	—
Academic support	8,556	—	—	8,556
Libraries	4,550	—	—	4,550
Student services	1,748	—	—	1,748
Institutional support	41,451	—	—	41,451
Total educational and general	639,645	—	—	639,645
Auxiliary enterprises	966	—	—	966
Actuarial loss on annuity obligations	—	—	954	954
Unrealized (gain) on interest rate swap	(8,291)	—	—	(8,291)
Total expenses and losses	632,320	—	954	633,274
Cumulative effect of change in accounting principle	(1,370)	—	—	(1,370)
Increase in net assets	45,893	10,265	6,593	62,751
Net assets at beginning of year	410,695	57,395	101,638	569,728
Net assets at end of year	\$ 456,588	67,660	108,231	632,479

See accompanying notes to consolidated financial statements.

WAKE FOREST UNIVERSITY

Statement of Activities

Reynolda House
(Supplementary Information)

Year ended June 30, 2006

(Dollars in thousands)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Revenues, gains, and other support:				
Educational and general:				
Student tuition and fees	\$ —	—	—	—
Scholarship allowance	—	—	—	—
Net student tuition and fees	—	—	—	—
Federal grants and contracts	—	—	—	—
State grants and contracts	—	—	—	—
Private gifts, grants, and contracts	748	367	—	1,115
Dividends, interest, and rents	501	53	—	554
Interest on short-term investments and other income	30	14	—	44
Net realized and unrealized appreciation on investments	5,997	642	—	6,639
Organized activities relating to educational department:				
Clinic services	—	—	—	—
Other sources	261	1	—	262
Total educational and general	7,537	1,077	—	8,614
Sales and services of auxiliary enterprises	—	—	—	—
Total revenues and gains	7,537	1,077	—	8,614
Net assets released from restrictions	590	(590)	—	—
Total revenues, gains, and other support	8,127	487	—	8,614
Expenses and losses:				
Educational and general:				
Instruction, departmental research, and clinical	—	—	—	—
Sponsored research, training, and other programs	—	—	—	—
Organized activities	—	—	—	—
Academic support	3,722	—	—	3,722
Libraries	—	—	—	—
Student services	—	—	—	—
Institutional support	—	—	—	—
Total educational and general	3,722	—	—	3,722
Auxiliary enterprises	—	—	—	—
Actuarial loss on annuity obligations	—	—	—	—
Other	(463)	(57)	(130)	(650)
Total expenses and losses	3,259	(57)	(130)	3,072
Cumulative effect of changes in account principles	—	—	—	—
Increase (decrease) in net assets	4,868	544	130	5,542
Net assets at beginning of year	48,721	586	2,200	51,507
Net assets at end of year	\$ <u>53,589</u>	<u>1,130</u>	<u>2,330</u>	<u>57,049</u>

See accompanying notes to consolidated financial statements.

WAKE FOREST UNIVERSITY
Consolidated Statement of Cash Flows
Year ended June 30, 2006
(with comparative financial information for the year ended June 30, 2005)
(Dollars in thousands)

	Supplementary information			2006	2005
	Reynolda Campus	WFUHS	Reynolda House		
Cash flows from operating activities:					
Increase in net assets	\$ 66,444	62,751	5,542	134,737	70,868
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:					
Depreciation and amortization	19,642	26,612	617	46,871	44,514
Net realized and unrealized appreciation on investments	(61,202)	(56,187)	(6,639)	(124,028)	(77,151)
Noncash gifts of property	(1,521)	(12,343)	(153)	(14,017)	(1,460)
Private gifts restricted for long-term investment	(8,211)	(4,409)	—	(12,620)	(16,005)
Other revenue restricted for long-term investment	(1,594)	(138)	—	(1,732)	(1,846)
(Gain) loss on disposal of property and equipment	(21)	1,825	—	1,804	2,797
Unrealized (gain) loss on interest rate swap	(1,739)	(8,291)	—	(10,030)	7,021
Bad debt expense	—	27,600	—	27,600	26,900
Cumulative effect of changes in accounting principles	8,666	1,370	—	10,036	—
Changes in assets and liabilities:					
Accounts and clinic receivables	(797)	(23,914)	29	(24,682)	(33,435)
Grants receivable	(476)	3,681	115	3,320	(1,700)
Contributions receivable	3,019	1,834	44	4,897	(387)
Notes receivable	(182)	(37)	—	(219)	289
Other assets and other liabilities and deferrals	5,408	9,949	56	15,413	14,424
Accounts payable and accruals	(2,757)	6,356	(654)	2,945	19,945
Postretirement benefits	855	1,312	—	2,167	(659)
Annuities payable	977	541	—	1,518	7,708
Net cash provided by (used in) operating activities	<u>26,511</u>	<u>38,512</u>	<u>(1,043)</u>	<u>63,980</u>	<u>61,823</u>
Cash flows from investing activities:					
Purchases of land, buildings, and equipment	(16,950)	(7,299)	(388)	(24,637)	(73,606)
Proceeds from sale of property and equipment	1,178	—	—	1,178	939
Purchases of investments in real estate	—	(56,675)	—	(56,675)	(855)
Disbursements of loans to students, faculty, and staff	(4,066)	(83)	—	(4,149)	(3,843)
Repayments of loans from students, faculty, and staff	3,856	354	—	4,210	3,472
Purchases of investments	(352,722)	(105,564)	(19,142)	(477,428)	(479,234)
Net proceeds from sales and maturities of investments	350,018	93,343	20,137	463,498	466,049
Net cash provided by (used in) investing activities	<u>(18,686)</u>	<u>(75,924)</u>	<u>607</u>	<u>(94,003)</u>	<u>(87,078)</u>
Cash flows from financing activities:					
Change in government grants refundable	(175)	(144)	—	(319)	(377)
Payments on notes payable	(667)	(920)	—	(1,587)	(1,543)
Proceeds from notes payable	—	39,656	—	39,656	23,312
Payments on bonds payable	(3,725)	(2,900)	—	(6,625)	(71,515)
Proceeds from issuance of bonds payable	—	—	—	—	67,365
Payments on bond issuance costs	—	—	—	—	(575)
Proceeds from private gifts restricted for long-term investment	8,211	4,409	—	12,620	16,005
Net realized gains restricted for long-term investment	595	1,313	—	1,908	167
Other revenue restricted for long-term investment	1,594	138	—	1,732	1,846
Net cash provided by financing activities	<u>5,833</u>	<u>41,552</u>	<u>—</u>	<u>47,385</u>	<u>34,685</u>
Net increase (decrease) in cash and cash equivalents	13,658	4,140	(436)	17,362	9,430
Cash and cash equivalents at beginning of year	12,552	6,972	1,009	20,533	11,103
Cash and cash equivalents at end of year	<u>\$ 26,210</u>	<u>11,112</u>	<u>573</u>	<u>37,895</u>	<u>20,533</u>
Supplemental disclosure of cash flow information:					
The University paid \$12,529 in interest during 2006.					

See accompanying notes to consolidated financial statements.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

(1) Summary of Significant Accounting Policies

(a) Description of the University

Wake Forest University (the University) is a private, coeducational, not-for-profit institution of higher education and research located in Winston-Salem, North Carolina. The consolidated financial statements of the University include the College of Arts and Sciences, Schools of Law, Management, and Divinity (the Reynolda Campus), the Reynolda House, Inc. (Reynolda House), Wake Forest University Health Sciences (WFUHS) and all entities over which the University has control, including all of the subsidiaries of WFUHS. All significant intercompany balances and transactions have been eliminated in consolidation. The consolidated financial statements have, in all material respects, been prepared on the accrual basis in conformity with the accounting principles generally accepted in the United States of America.

(b) Basis of Presentation

Net assets and revenues, expenses, gains and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the University and changes therein are classified and reported as follows:

- Unrestricted net assets – net assets that are not subject to donor-imposed stipulations.
- Temporarily restricted net assets – net assets subject to donor-imposed stipulations that may or will be met either by actions of the University and/or the passage of time.
- 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 University to use all of, 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 stipulations or by law. Expirations of 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 to be received after one year are discounted to their present value at a risk free investment rate, generally the 10-year treasury bill rate for the Reynolda Campus (5.15% at June 30, 2006) and the 3-year treasury bill rate for WFUHS (5.13% at June 30, 2006). Amortization of discounts 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

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

judgment, based on such factors as prior collection history, type of contribution and nature of fundraising activity.

Income and realized and unrealized gains on investments of permanently restricted net assets are reported as follows:

- as increases in permanently restricted net assets if the terms of the gift or the University's interpretation of relevant state law 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 gifts impose restrictions on their use;
- as increases in unrestricted net assets in all other cases.

(c) *Endowment Accounting*

Permanent endowment funds are subject to the restrictions of gift instruments, which require that the principal be invested in perpetuity. While quasi-endowment funds have been established by the board of trustees for the same purpose as permanent endowment funds, any portion of the quasi-endowment funds may be expended at the discretion of the Board and, accordingly, such funds are reported as unrestricted net assets. Realized and unrealized gains of the permanent endowment funds are classified as temporarily restricted net assets if the income distributed from these funds is restricted, and as unrestricted net assets if the income distributed from these funds is unrestricted.

The University has implemented a spending policy designed to stabilize annual spending levels and preserve the real value of the endowment over time. In accordance with the University's policy, a predetermined endowment spending rate consistent with the University's total return objective has been established and approved by the Board of Trustees. Should endowment yields prove to be insufficient to support this policy, the balance is provided from capital gains. Should endowment yields exceed the amounts necessary to maintain this objective, the balance is reinvested in the endowment. The endowment spending rate for the years ended June 30, 2006 and 2005 was 5.3%, calculated as a percentage of the average of the previous three-year semiannual moving market value per unit (see note 3).

(d) *Temporarily Restricted Accounting*

Revenues, which have donor stipulations that limit their use, are recorded as temporarily restricted net assets and released from restriction when the stipulated time restriction expires or purpose restriction is met.

(e) *Cash Equivalents*

For purposes of reporting cash flows, the University considers interest-bearing deposits in financial institutions with remaining maturities at date of purchase of three months or less to be cash equivalents. Cash equivalents consist primarily of temporary investments in bank repurchase agreements and money market accounts.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

(f) *Financial Instruments*

The carrying amounts of cash and cash equivalents; accounts, grants, and clinic receivables and accounts payable approximate fair value because of the short maturity of these financial instruments.

The carrying value of investments in debt securities and equity securities is based upon fair value. In the limited cases where such values are not available, estimates of fair value are used.

The carrying amounts of contributions receivable and annuities payable represent the present value of estimated future cash flows, which approximates fair value.

A reasonable estimate of the fair value of notes receivable from students under government loan programs cannot be made because such loans are not sellable and can only be assigned to the U.S. government or its designees. The fair value of receivables from students under University loan programs approximates carrying value.

The carrying amounts of notes and bonds payable with variable interest rates approximate their fair value because substantially all of these financial instruments bear interest at variable rates which approximate current market rates for loans with similar maturities and credit quality.

(g) *Split-Interest Agreements*

The University's split-interest agreements with donors consist primarily of irrevocable charitable remainder trusts for which the University serves as trustee. Assets held in these trusts are included in investments or investments in real estate. Contribution revenues are recognized at the dates the trusts are established. Annuity and other split-interest obligations are adjusted annually at the end of each fiscal year.

(h) *Investments*

Investments are generally recorded at fair value, which are based on quoted market prices. In the case of certain less marketable investments, principally private equity investments, value is established based on certain external events which substantiate a change in value or a reasonable methodology that exists to capture and quantify changes in value. Where the University's ownership is considered to be more than minor, the equity method of accounting is used. The University receives income from perpetual trusts but will never gain control of the trusts. These trusts are recorded at fair value with carrying values adjusted annually for changes in fair value.

(i) *Investments in Real Estate*

Investments in real estate are valued at the lower of cost or market as they are considered to be operating assets of the University. Accordingly, if there is a decline in market value that is other than temporary, the carrying amount of the investment is reduced to market value. The University records depreciation on rental properties over 40 years, which is the estimated useful life of the rental properties. Depreciation is calculated using the straight-line method.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

Under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the University records long-lived assets for which management and the Board of Trustees has committed to a plan to sell the asset. At June 30, 2006, \$69,906 is included in investments in real estate which is available for immediate sale in its present condition subject only to the terms that are usual and customary for sales of such assets. The University intends to complete the sale within one year with remaining actions unlikely to significantly change the plan to sell. At June 30, 2006, \$26,710 is included in investments in real estate that is related to real estate held for lease.

In accordance with SFAS No. 144, the assets are not depreciated while classified as held for sale.

(j) Land, Buildings, and Equipment

Land, buildings, and equipment are recorded at cost at date of acquisition or estimated fair market value on the date received for donated items. Depreciation is calculated on the straight-line basis over the estimated useful life of each class or component of depreciable asset. Estimated lives range from 3 to 60 years. Gains or losses on the disposal of land, buildings, and equipment are included in the consolidated statement of activities.

(k) Works of Art and Historical Treasures

Works of art and historical treasures include the original Reynolda House and its contents, as well as paintings and other items subsequently acquired. The Reynolda House, Inc. has capitalized all such items since its inception. If purchased, they are capitalized at cost, and if donated, they are capitalized at their appraised or estimated fair value. The Reynolda House's paintings are cataloged for educational, research, scientific and curatorial purposes, and activities verifying their existence and assessing their condition are performed on an ongoing basis. The works of art and historical treasures are included with buildings and other improvements and equipment and furnishings and are not depreciated (see note 5).

(l) Clinic Services Revenue

WFUHS records clinic services revenue net of contractual adjustments and discount allowances. WFUHS has agreements with third-party payors that provide for payments to WFUHS at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges and per diem payments. Clinic services revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined. The clinic receivables are recorded net of allowance for contractual adjustments and uncollectible accounts of \$36,479 and \$33,698, respectively, at June 30, 2006; and \$26,167 and \$33,112, respectively, at June 30, 2005.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

for patient services, and Medicare and Medicaid fraud and abuse. Recently, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Compliance with these and other laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

(m) Bond Issuance Costs

Bond issuance costs related to the registration and issuance of bonds are carried at cost less accumulated amortization, are being amortized over the life of the bonds on a method that approximates the effective interest method and are included in other assets in the consolidated statement of financial position.

(n) Functional Expenses

Expenses are reported in the consolidated statement of activities in functional categories recommended by the National Association of College and University Business Officers. The expenses are reported in these functional categories after the allocation for depreciation of plant assets, interest expense, and plant operation and maintenance expense. The University's primary program services are instruction, clinical, research, and organized activities. Expenses reported as academic support, libraries, student services, institutional support, and auxiliary enterprises are incurred in support of these primary program services. The University's fundraising expenses are immaterial and are included in institutional support.

Depreciation of plant assets, interest expense and plant operation and maintenance expense are allocated to program and supporting activities based on periodic inventories of facilities.

(o) Government Grants Refundable

Funds provided by the United States Government under the Federal Perkins and Health Professions Student Loan Programs are loaned to qualified students and may be re-loaned after collections. These funds are ultimately refundable to the government and are reported as liabilities.

(p) Sponsored Grants and Contracts

Revenue under grants and contracts with sponsoring organizations are recognized as expenses as incurred for agreement purposes. The revenues include recoveries of indirect costs and fringe benefits, which are generally determined as a negotiated or agreed-upon percentage of direct costs with certain exclusions.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

(q) *Derivative Instruments*

Under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities, an Amendment of SFAS 133*, the University records all derivative instruments on the consolidated statement of financial position at their respective fair values and all changes in fair value in the consolidated statement of activities.

(r) *Allocated Net Assets*

WFUHS's unrestricted undesignated net asset balance is internally allocated for individual departmental research and development and for use in the clinical practices.

(s) *New Accounting Pronouncement*

In March 2005, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations*, which is an interpretation of Statement of Financial Accounting Standards No. 143 (SFAS 143), *Accounting for Asset Retirement Obligations*. FIN 47 clarifies terminology within SFAS 143 and requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005.

The University identified legal retirement obligations related to asbestos abatement, hazardous material and petroleum tank removals. The University estimated the asbestos abatement using site-specific surveys where available and recent abatement removal costs for similar asbestos material. The University estimated hazardous material and petroleum tank removal costs using recent vendor charges. University projected inflation rates were based on vendor estimates.

FIN 47 requires that the estimate be recorded as a liability and as an increase to the related asset. The capitalized portion is depreciated over the remaining useful life of the related assets. The University estimated the remaining useful life associated with assets with conditional retirement obligations based on existing project plans or the average useful lives of similar assets.

The Reynolda Campus recorded site improvements of \$2,548, related accumulated depreciation of \$962, an asset retirement obligation (included in other liabilities and deferrals) of \$10,296, and a cumulative effect of change in accounting principle of \$8,666. WFUHS recorded site improvements of \$3,330, related accumulated depreciation of \$1,651, an asset retirement obligation (included in other liabilities and deferrals) of \$3,241, and a cumulative effect of change in accounting principle of \$1,370.

(t) *Use of Estimates*

The University prepares its consolidated financial statements in accordance with accounting principles generally accepted in the United States of America which require management to make estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include the carrying amount of property, plant, and equipment and investments in real estate, valuation allowances for receivables, environmental liabilities, assets and obligations related to employee benefits. Actual results could differ from those estimates.

(u) Reclassifications

In certain instances, amounts previously reported in the 2005 consolidated financial statements have been reclassified to conform to the 2006 presentation. Such reclassifications have no effect on the increase in net assets as previously reported.

(v) Comparative Financial Information

The financial statements include certain prior year information for comparative purposes, which does not include sufficient detail to constitute a presentation in conformity with accounting principles generally accepted in the United States of America.

Accordingly, such information should be read in conjunction with the University's consolidated financial statements for the year ended June 30, 2005 from which this information was derived.

(2) Contributions Receivable

The following is an analysis of the maturities of the University's contributions receivable at June 30, 2006:

	<u>Reynolda Campus</u>	<u>WFUHS</u>	<u>Reynolda House</u>	<u>Total</u>
One year or less	\$ 10,770	2,290	67	13,127
Between one and five years	33,451	2,014	28	35,493
More than five years	10,934	2,774	—	13,708
Gross contributions receivable	55,155	7,078	95	62,328
Less estimated uncollectible amounts	10,970	335	9	11,314
Less discount to present value	6,240	1,405	2	7,647
Contributions receivable, net	<u>\$ 37,945</u>	<u>5,338</u>	<u>84</u>	<u>43,367</u>

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

(3) Investments

Investments at June 30, 2006 consist of the following:

Short-term investments	\$	150,687
Real assets		89,921
Real estate		43,330
Fixed income securities		114,272
Beneficial interests in perpetual trusts		25,304
Public equity		538,925
Private equity		56,143
Hedge strategies		151,218
Other investments		<u>1,618</u>
Total investments	\$	<u><u>1,171,418</u></u>

The University places a substantial portion of assets into a pool on a fair value basis, with each individual fund subscribing to or disposing of units on the basis of the fair value per unit at the beginning of each quarter within which the transaction took place. At June 30, 2006, a total of 17,449,159 units existed in the pool with a fair value of \$52.89 per unit.

Net realized and unrealized appreciation on investments is decreased by \$4,680 in investment fees.

(4) Investments in Real Estate

The University maintains rental properties and has entered into long-term operating lease agreements for this real estate providing for future rental income as follows:

	<u>Reynolda Campus</u>	<u>WFUHS</u>	<u>Total</u>
Year ended June 30:			
2007	\$ 8,293	2,057	10,350
2008	8,406	617	9,023
2009	8,796	340	9,136
2010	9,648	250	9,898
2011	<u>9,767</u>	<u>208</u>	<u>9,975</u>
	\$ <u><u>44,910</u></u>	<u><u>3,472</u></u>	<u><u>48,382</u></u>

Total income from rental real estate was \$8,188 for the Reynolda Campus and \$1,935 for WFUHS for the year ended June 30, 2006.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

(5) Land, Buildings, and Equipment

Land, buildings, and equipment is summarized as follows at June 30, 2006:

	<u>Reynolda Campus</u>	<u>WFUHS</u>	<u>Reynolda House</u>	<u>Total</u>
Land	\$ 5,649	33,007	1,122	39,778
Buildings and other improvements	336,899	342,980	15,018	694,897
Equipment and furnishings	146,187	110,575	10,712	267,474
Construction in progress	5,896	28,164	—	34,060
	<u>494,631</u>	<u>514,726</u>	<u>26,852</u>	<u>1,036,209</u>
Less accumulated depreciation	<u>(266,235)</u>	<u>(226,684)</u>	<u>(2,907)</u>	<u>(495,826)</u>
	<u>\$ 228,396</u>	<u>288,042</u>	<u>23,945</u>	<u>540,383</u>

Total depreciation expense on buildings and equipment was \$46,719 for the year ended June 30, 2006.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

(6) Notes and Bonds Payable

Notes and bonds payable at June 30, 2006 consist of the following:

	<u>Reynolda Campus</u>	<u>WFUHS</u>	<u>Total</u>
Variable rate loan (6.08% at June 30, 2006) with principal of \$77 and interest payable monthly and final balloon payment due December 31, 2011	\$ —	14,720	14,720
Variable rate loan (4.19% at June 30, 2006) with \$480 of principal and interest payable semiannually through 2014	6,468	—	6,468
Variable rate construction loan agreement (5.63% at June 30, 2006) with interest payable monthly and final principal and interest balloon payment due November 30, 2006	—	62,968	62,968
Noninterest bearing promissory note due September 2012	—	800	800
Notes payable	<u>\$ 6,468</u>	<u>78,488</u>	<u>84,956</u>
Series 1994 taxable bonds payable	\$ 1,400	—	1,400
Series 1997 taxable bonds payable	7,500	—	7,500
Series 2002 tax-exempt bonds payable	—	193,150	193,150
Series 2004A tax-exempt bonds payable	36,605	—	36,605
Series 2004B tax-exempt bonds payable	30,465	—	30,465
Bonds payable	<u>\$ 75,970</u>	<u>193,150</u>	<u>269,120</u>

WFUHS entered into a construction loan financing agreement in 2005, which was amended in 2006, with a commercial bank that permits WFUHS to borrow through November 2006 up to \$85,000, bearing interest at LIBOR plus 0.30% (5.63% at June 30, 2006). Accrued interest is payable monthly. Upon completion of the construction, permanent financing will be obtained to repay the existing construction loan.

WFUHS received a grant from the City of Winston-Salem (the City) for \$800 in 2003, the purpose of which was to fund the development of the Green Park Courtyard (the Park). As part of this grant, WFUHS executed a noninterest bearing promissory note to the City in the amount of \$800 and a deed of trust subjecting the Park to the lien of the promissory note. The grant states that in the event that an additional \$17,400 in taxable property value is created within the Park within ten years, then the promissory note shall be marked satisfied in full and cancelled of record. At such time that this condition is fulfilled, the note will be recorded as a contribution in the consolidated statement of activities.

The University has outstanding \$1,400 of taxable variable rate demand bonds, Series 1994, pursuant to a trust agreement with a commercial bank. The Series 1994 bonds mature serially through 2009 in the

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

amount of \$600 in 2007 and 2008, with the remainder due in 2009. The variable interest rate is determined weekly and at the option of the University may be converted to an alternative variable rate option or to a fixed rate. The University has an unconditional obligation to repay the bonds and certain property and rights with an approximate net book value of \$21,041 are pledged and assigned as security under terms of the bond indenture. The interest rate on the bonds at June 30, 2006 was 5.4%.

The University has outstanding \$7,500 of Wake Forest University taxable variable demand rate bonds Series 1997 (the Series 1997 taxable bonds) pursuant to a trust agreement with a commercial bank. The Series 1997 taxable bonds mature annually from 2010 through 2017 in varying amounts of \$800 to \$1,100. The variable interest rate is determined weekly and at the option of the University may be converted to an alternative variable option or to a fixed rate. (A letter of credit has been issued by a commercial bank for \$7,663, which expires on September 5, 2006). The University's obligation under the loan agreement is an unsecured, unconditional obligation. The interest rate on the bonds at June 30, 2006 was 5.35%.

WFUHS has outstanding \$193,150 of Wake Forest University Health Care Facilities Revenue Bonds, Series 2002, issued by the North Carolina Medical Care Commission. The bonds payable are comprised of Subseries A and Subseries B, each in the amount of \$99,400. The obligations of WFUHS are evidenced by a promissory note issued under a Master Trust Indenture, dated August 1, 2002, by and between WFUHS and First Citizens Bank and Trust Company, as master trustee. The Series 2002 bonds mature in full in 2034 and, at the option of WFUHS, the bonds may be converted to various interest rates or to a fixed rate. Subject to certain provisions regarding serialization, the Series 2002 bonds are subject to mandatory redemption through 2034 in increasing annual amounts from \$2,750 to \$12,950. The interest rates on the bonds at June 30, 2006 were variable at 3.80% for the Subseries A and variable at 3.74% for Subseries B (note 13).

The University has outstanding \$67,070 of tax-exempt North Carolina Facilities Finance Agency Revenue Bonds, Series 2004. The bonds are made up of Subseries A in the amount of \$36,605, and Subseries B, in the amount of \$30,465. The obligations of the University are evidenced by a Loan Agreement dated December 1, 2004, by and between the University and First Citizens Bank and Trust Company, as trustee. The Series 2004 tax-exempt bonds are due annually through 2020 in varying amounts from \$305 to \$7,340. The interest rate on the bonds is determined weekly, and at the option of the University may be converted to a fixed rate. The University's obligation under the Loan Agreement is an unsecured, unconditional obligation. The interest rates on the bonds at June 30, 2006 were variable at 3.91% for the Subseries A and at 3.95% for the Subseries B.

Trust indentures underlying the Series 1994 and Series 1997 taxable bonds, Series 2002 and Series 2004 tax-exempt bonds contain certain covenants and restrictions. At June 30, 2006, management believes the University is in compliance with such requirements.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

Aggregate annual maturities of notes and bonds payable for each of the five fiscal years subsequent to June 30, 2006 and thereafter are as follows:

	<u>Reynolda Campus</u>	<u>WFUHS</u>	<u>Total</u>
2007	\$ 1,601	66,938	68,539
2008	1,641	4,170	5,811
2009	3,266	4,320	7,586
2010	6,008	4,520	10,528
2011	6,192	4,720	10,912
Thereafter	63,730	186,970	250,700
	<u>\$ 82,438</u>	<u>271,638</u>	<u>354,076</u>

Total interest costs incurred on indebtedness were \$10,081 for the year ended June 30, 2006.

(7) Postretirement Benefits

The University sponsors defined benefit postretirement medical and dental plans that cover all its full-time employees who elect coverage and satisfy the plans' eligibility requirements when they retire. To be eligible, retired employees of the Reynolda Campus must be at least 62 years of age with ten or more years of service or be at least 65 years of age with five or more years of service. Retired employees of WFUHS must satisfy the "Rule of 75," meaning that the employee's age and years of service must equal or exceed seventy-five at retirement with a minimum age of fifty-five. Employees of the Reynolda House are not eligible for the plans. The plans are contributory with retiree contributions established based on the University contributions being fixed amounts.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

The following table provides a reconciliation of the changes in each plan's benefit obligation, fair value of plan assets and funded status for the year ended June 30, 2006:

	Reynolda Campus	WFUHS	Total
Change in benefit obligation:			
Benefit obligation at beginning of year	\$ 9,495	35,462	44,957
Service cost	603	1,912	2,515
Interest cost	488	1,834	2,322
Actuarial gain	(1,763)	(4,505)	(6,268)
Benefits paid	(342)	(1,128)	(1,470)
Change in plan provisions	—	716	716
Benefit obligation at end of year	<u>8,481</u>	<u>34,291</u>	<u>42,772</u>
Change in plan assets:			
Fair value of plan assets at beginning of year	—	16,352	16,352
Actual return on plan assets	—	3,366	3,366
Employer contributions	342	2,104	2,446
Benefits paid	<u>(342)</u>	<u>(1,128)</u>	<u>(1,470)</u>
Fair value of plan assets at end of year	<u>—</u>	<u>20,694</u>	<u>20,694</u>
Funded status	(8,481)	(13,597)	(22,078)
Unrecognized net actuarial loss	(575)	2,155	1,580
Unrecognized prior service cost	449	9,154	9,603
Net liability recognized	<u>\$ (8,607)</u>	<u>(2,288)</u>	<u>(10,895)</u>

The following table provides the components of net periodic benefit cost for the year ended June 30, 2006:

	Reynolda Campus	WFUHS	Total
Service cost	\$ 603	1,912	2,515
Interest cost	488	1,834	2,322
Expected return on plan assets	—	(1,537)	(1,537)
Amortization of unrecognized amounts	105	919	1,024
Recognized net actuarial loss	—	288	288
Net periodic benefit cost	<u>\$ 1,196</u>	<u>3,416</u>	<u>4,612</u>

The prior service costs are amortized on a straight-line basis over the average remaining service period of active participants. Gains in excess of 10% of the greater of the benefit obligation and the market-related value of assets are amortized over the average remaining service period of active participants.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

The weighted average discount rate used to determine the accumulated postretirement benefit obligation was 6.25% and 5.25% at June 30, 2006 and 2005, respectively. The discount rate is determined based on analysis of various high quality fixed income indices, such as the Moody's AA Corporate Bond rate. For management purposes, a 10.5% annual rate of increase in the per capita cost of covered health care benefits was assumed for the first year, and a 4% rate was assumed as the ultimate rate. The expected return assumed on plan assets for WFUHS is 9%. The rate is reviewed annually and adjusted as appropriate to reflect changes in the expected market performance of the investments.

Plan assets for WFUHS are held in trust and are invested in commingled mutual funds that preclude the ability to analyze the precise composition of the investments, thus no asset detail is presented.

Assumed health care cost trend rates have a significant effect on the amounts reported for the post-retirement benefit plan. A 1% change in assumed health care cost trend rates would have the following effects:

	<u>1% increase</u>	<u>1% decrease</u>
Effect on total service and interest cost components of net periodic benefit cost	\$ 226	(198)
Effect on postretirement benefit obligation	1,375	(1,236)

In May 2004, the Financial Accounting Standards (FASB) issued FASB Staff Position No. 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* (the Act). The Act introduces a prescription drug benefit under Medicare (Medicare Part D). The availability of the new drug benefit could cause plan participants to leave their current employer-sponsored plans depending on the drug benefits provided under those plans relative to the benefits provided by Medicare. The Act also provides that a nontaxable federal subsidy will be paid to sponsors of the postretirement benefit plans that provide retirees with a drug benefit that is at least "actuarially equivalent" to the Medicare Part D benefit. During 2005, the University assessed the impact of the Act on its plans noting that since it was a Medicare replacement plan they are not eligible for reimbursement. Further, the University deems the drug coverage provided by the plans superior to Medicare Part D and, as such, there is no impact on the accumulated postretirement benefit obligation.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

Aggregate benefits expected to be paid by the University in each of the next ten fiscal years subsequent to June 30, 2006 are as follows:

	Reynolda Campus	WFUHS	Total
2007	\$ 371	1,184	1,555
2008	415	1,390	1,805
2009	480	1,604	2,084
2010	530	1,821	2,351
2011	570	1,967	2,537
Five years thereafter	3,935	13,716	17,651
	\$ <u>6,301</u>	<u>21,682</u>	<u>27,983</u>

The expected benefits to be paid are based on the same assumptions used to measure the University's benefit obligation at June 30, 2006 and include estimated future employee service.

(8) Net Assets

Temporarily restricted net assets are available for the following purposes at June 30, 2006:

	Reynolda Campus	WFUHS	Reynolda House	Total
Instruction, research, scholarships and operations	\$ 26,686	24,725	—	51,411
Term endowment funds	156,988	42,935	1,130	201,053
Interests in other trusts	3,901	—	—	3,901
	\$ <u>187,575</u>	<u>67,660</u>	<u>1,130</u>	<u>256,365</u>

During 2006, net assets of \$40,368 were released from donor restrictions by incurring expenses satisfying the restricted purposes or by the passage of time.

Permanently restricted net assets consist of the following at June 30, 2006:

	Reynolda Campus	WFUHS	Reynolda House	Total
Student loan funds	\$ 7,832	4,033	—	11,865
Permanent endowment funds	154,294	79,215	2,330	235,839
Interests in perpetual and other trusts	4,056	24,983	—	29,039
	\$ <u>166,182</u>	<u>108,231</u>	<u>2,330</u>	<u>276,743</u>

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

The income from these investments in perpetuity is expendable for research, instruction, scholarships, and operations.

(9) Benefit Plans

Substantially all employees of the University are eligible to participate in defined contribution benefit plans. The University contributes a specified percentage of each employee's salary to the plans. Total contributions for the year ended June 30, 2006 were \$6,838, \$18,559, and \$109 for the Reynolda Campus, WFUHS, and Reynolda House, respectively.

(10) Related Party Transactions

WFUHS and the North Carolina Baptist Hospital, Inc. and subsidiaries (the Hospital) participate in various expansion projects, share certain facilities and provide various services and incur certain expenses on behalf of each other. The costs associated with operating and maintaining jointly occupied facilities are ultimately paid by the party having beneficial occupancy.

During the year ended June 30, 2006, \$51,398 was received from the Hospital for reimbursement of services provided or expenses incurred by WFUHS on behalf of the Hospital. Such services or expenses include physician salaries, facility expenses, library expenses, printing services, laboratory services and materials. Accounts payable and accruals at June 30, 2006, include \$50 due from the Hospital for such items. During the year ended June 30, 2006, \$44,093 was paid to the Hospital for reimbursement of services provided or expenses incurred by the Hospital on behalf of WFUHS. Such services or expenses include laboratory fees collected by the Wake Forest University Physicians business office, computer services, telephone service, insurance premiums, and certain utilities. Accounts payable and accruals at June 30, 2006, include \$1,288 due to the Hospital for such items.

The Medical Center Corporation (the Center), a North Carolina nonprofit corporation formed to act on behalf of WFUHS and the Hospital in connection with facilities planning, informational services, fundraising and budget formulation and review, is directing the planning and supervision of numerous construction projects as well as the fundraising campaigns in connection therewith. Construction costs are paid in accordance with the respective occupancy percentages of the facilities. WFUHS and the Hospital have negotiated a land and facilities sharing agreement whereby WFUHS and the Hospital independently hold title to certain land and facilities, as designated by the agreement.

(11) Contingencies and Other Commitments

The estimated cost to complete construction in progress at June 30, 2006 is \$2,137 and \$26,742 for the Reynolda Campus and WFUHS, respectively.

Grant awards not yet funded and for which services have not yet been performed are not recorded until services have been performed. At June 30, 2006, such grant awards amounted to \$3,921 and \$171,104 for the Reynolda Campus and WFUHS, respectively.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

Expenditures and indirect costs related to federal and state grants and contracts are subject to adjustment based upon review by the granting agencies. The amounts, if any, of expenditures, which may be disallowed by the granting agencies cannot be determined at this time, although management expects they will not have a material effect on the University's financial position.

The University is involved in various legal actions occurring in the normal course of activities. While the final outcomes cannot be determined at this time, management is of the opinion that the resolution of these legal actions will not have a material effect on the University's financial position.

(12) Professional Liability Insurance

WFUHS maintains professional liability coverage on a combined basis with the North Carolina Baptist Hospital (the Hospital) (see note 10), which includes a \$4,000 per occurrence and a \$16,000 annual aggregate for the year ended June 30, 2006. WFUHS estimates its professional liability on a discounted actuarial basis. The discount rate at June 30, 2006 was 5.5%. Accrued professional liability costs, including estimated claims incurred but not reported, amounted to \$26,702 at June 30, 2006, and are included in other liabilities and deferrals in the accompanying consolidated statement of financial position. In the opinion of management, adequate provision has been made for the related risk.

(13) Derivative Instruments and Other Financial Instruments

The University has only limited involvement with derivative financial instruments and does not use them for trading purposes. In the normal course of its business, WFUHS entered into a long-term interest rate swap agreement having a notional amount of \$90,000, which effectively fixed the interest rate on the Series 2002B variable rate bond issue at 3.67% through July 1, 2034. WFUHS receives 67% of LIBOR (London InterBank Offered Rate) and makes payments at 3.67% and settles with the counterparty on a monthly basis. LIBOR is the interest rate index used as a basis for repricing the Series 2002B variable rate bonds, however, the rate may vary from LIBOR in any rate period. WFUHS selected the combination of a variable rate bond issue and long-term interest rate swap agreement to obtain fixed rate financing at the lowest available cost at the time of the transaction. The net settlement amount incurred on the swap is included in interest expense. The fair value of the interest rate swap is the estimated amount WFUHS would receive or pay to terminate the swap agreement at the reporting date, taking into account current interest rates and the current creditworthiness of the swap counterparties. At June 30, 2006, the fair value of the interest rate swap is an asset of \$1,539.

WAKE FOREST UNIVERSITY

Notes to Consolidated Financial Statements

June 30, 2006

(Dollars in thousands)

In the normal course of its business, the Reynolda Campus entered into two long-term interest rate swap agreements having a total notional amount of \$30,465, which effectively fixed the interest rate on the Series 2004B variable rate bond issue at 3.019% through June 30, 2018. The Reynolda Campus receives 68% of LIBOR and makes payments of 3.019% and settles with each counterparty on a monthly basis. BMA is the interest rate index used as a basis for repricing the Series 2004B variable rate bonds, however, the rate may vary from BMA in any rate period. The Reynolda Campus selected the combination of a variable rate bond issue and long-term interest rate swap agreement to obtain fixed rate financing at the lowest available cost at the time of the transaction. The net settlement amount incurred on the swap is included in interest expense. The fair value of the interest rate swap is the estimated amount the Reynolda Campus would receive or pay to terminate the swap agreement at the reporting date, taking into account current interest rates and the current creditworthiness of the swap counterparties. At June 30, 2006, the fair value of the interest rate swap is an asset of \$1,408.

The University is exposed to credit loss in the event of nonperformance by each counterparty to its long-term interest rate swaps.

(14) Income Taxes

The University is a tax-exempt organization as described in Section 501(c)(3) of the Internal Revenue Code (the Code) and is generally exempt from federal income taxes on related income pursuant to Section 501(a) of the Code. Accordingly, no provision for income taxes is made in the consolidated financial statements.

WAKE FOREST UNIVERSITY
Schedule of Expenditures of Federal and State Awards
Year ended June 30, 2006

Federal and state grantors/pass-through grantors/agencies, or cluster title	Federal CFDA Number	Expenditures
Federal Award Expenditures:		
Research and Development Cluster:		
Wake Forest University Health Sciences:		
Department of Health and Human Services:		
National Institutes of Health	93.RD	\$ 113,206,252
Agency for Healthcare Research and Quality	93.RD	404,237
Center for Disease Control & Prevention	93.RD	1,034,923
Health Resources and Services Administration	93.RD	743,534
DHHS Pass-through programs from:		
Albert Einstein College of Medicine	93.RD	620,036
Association of Teachers of Preventive Medicine	93.RD	394,147
Booz Allen Hamilton	93.RD	108,670
Brown University	93.RD	21,593
Cancer & Leukemia Group B Foundation	93.RD	155,192
Case Western Reserve University	93.RD	175,721
Cedars-Sinai Medical Center	93.RD	359,209
Children's Hospital, Boston	93.RD	493,908
Children's Hospital, Cincinnati	93.RD	119,162
Children's Oncology Group	93.RD	92,115
Columbia University	93.RD	46,326
Constella Health Sciences	93.RD	30,762
Dartmouth University	93.RD	(45)
Duke University Clinical Research Institute	93.RD	24,230
Duke University	93.RD	832,309
Fred Hutchinson Cancer Research Center	93.RD	49,306
George Washington University	93.RD	26,195
Georgetown University	93.RD	134,687
Gynecologic Oncology Group	93.RD	110,263
Harvard University	93.RD	166,723
Henry M. Jackson Research Foundation	93.RD	12,411
Hipple Cancer Research Center	93.RD	72
Intermountain Healthcare	93.RD	8,432
Ixion Biotechnology, Inc.	93.RD	44,101
Jaeb Center for Health Research	93.RD	1,034
Johns Hopkins University	93.RD	485,905
Joslin Diabetes Center	93.RD	35
Kaiser Permanente Southern California	93.RD	11,587
Louisiana State University	93.RD	71,720
Massachusetts General Hospital	93.RD	(748)
Mayo Clinic	93.RD	232,470
Millar Instruments, Inc.	93.RD	60,143
Mt. Sinai Medical Center	93.RD	5,000
National Jewish Hospital	93.RD	12,165
National Marrow Donor Program	93.RD	15,232
New England Research Institute	93.RD	2,712
North Carolina Central University	93.RD	40,977
Oregon Health Sciences	93.RD	45,654
Pacific Health Research Institute	93.RD	161,071
Pennsylvania State University	93.RD	222,377
Plureon Corporation	93.RD	206,548
Southwest Oncology Group	93.RD	410
Stanford University	93.RD	96,674
State University of New York	93.RD	69,324
Strang Cancer Research Center	93.RD	74,649
Susan G. Koman Breast Cancer Foundation	93.RD	895
Transonic Systems, Inc.	93.RD	8,676
Tufts University	93.RD	132,014

WAKE FOREST UNIVERSITY

Schedule of Expenditures of Federal and State Awards

Year ended June 30, 2006

Federal and state grantors/pass-through grantors/agencies, or cluster title	Federal CFDA Number	Expenditures
Tulane University	93.RD	\$ 60,041
University of Alabama	93.RD	77,911
University of Arkansas	93.RD	162,089
University of California at Davis	93.RD	12,275
University of California at Los Angeles	93.RD	11,141
University of California at San Diego	93.RD	137,606
University of California at San Francisco	93.RD	90,045
University of Chicago	93.RD	87,483
University of Colorado	93.RD	90,761
University of Florida	93.RD	1,143,518
University of Illinois	93.RD	(12,792)
University of Kentucky	93.RD	7,880
University of Maryland	93.RD	317,404
University of Minnesota	93.RD	212,562
University of Mississippi	93.RD	63,323
University of North Carolina at Chapel Hill	93.RD	1,016,491
University of Pennsylvania	93.RD	414,459
University of Pittsburgh	93.RD	1,740,163
University of Rochester	93.RD	110
University of South Carolina	93.RD	73,189
University of Texas - SA	93.RD	61,615
University of Texas M.D. Anderson Cancer Center	93.RD	7,499
University of Utah	93.RD	6,601
University of Vermont	93.RD	18,081
University of Virginia	93.RD	70,962
University of Washington	93.RD	533,499
University of Wisconsin-Madison	93.RD	7,970
Van Andel Research Institute	93.RD	(30,036)
Vanderbilt University	93.RD	115,420
Washington University, St. Louis	93.RD	66,595
Winston-Salem State University	93.RD	76,678
World Precision Institute	93.RD	2,536
Wright State University	93.RD	13,489
Total Department of Health and Human Services		128,027,563
Department of Defense:		
Defense Advance Research Project	12.RD	2,203,059
U.S. Army	12.RD	2,032,941
DOD Pass-through programs from:		
Duke University	12.RD	30,275
Henry M. Jackson Research Foundation	12.RD	54,315
Ohio State University	12.RD	(2,809)
University of North Carolina at Chapel Hill	12.RD	43,096
University of Texas SW Medical Center - Dallas	12.RD	8,062
U.S. Civilian Research and Development Foundation	12.RD	4,963
Total Department of Defense		4,373,902
Department of Justice:		
Department of Justice	16.RD	120,308
National Institute of Justice	16.RD	622,500
Office of Juvenile Justice and Delinquency Prevention	16.RD	205,199
Total Department of Justice		948,007
Department of Agriculture	10.RD	5,520
Department of Commerce	11.RD	45
Department of State	19.RD	2,564
Department of Veterans Affairs	64.RD	113,492
Environmental Protection Agency	66.RD	160,740
National Aeronautics and Space Administration	43.RD	373,267
National Science Foundation	47.RD	86,692

WAKE FOREST UNIVERSITY
Schedule of Expenditures of Federal and State Awards
Year ended June 30, 2006

Federal and state grantors/pass-through grantors/agencies, or cluster title	Federal CFDA Number	Expenditures
Subtotal – Wake Forest University Health Sciences		\$ 134,091,792
College of Arts and Sciences, Schools of Law, Management, and Divinity:		
Department of Health and Human Services:		
National Institute of Health	93.RD	2,553,715
Total Department of Health and Human Services		2,553,715
Department of Defense:		
U.S. Army	12.RD	143,256
U.S. Air Force	12.RD	632,000
Total Department of Defense		775,256
National Science Foundation	47.RD	1,323,580
National Aeronautics and Space Administration	43.RD	4,037
Department of State	19.RD	10,500
Subtotal – College of Arts and Sciences, Schools of Law, Management, and Divinity		4,667,088
Total Research and Development Cluster		138,758,880
Student Financial Aid Cluster:		
Wake Forest University Health Sciences:		
Department of Education:		
Federal Family Education Loan Program	84.032	14,006,865
Subtotal – Wake Forest University Health Sciences		14,006,865
College of Arts and Sciences, Schools of Law, Management, and Divinity:		
Department of Education:		
Federal Supplemental Educational Opportunity Grant	84.007	379,898
Federal Family Education Loan Program	84.032	31,114,150
Federal Work Study Program	84.033	1,292,271
Federal Perkins Loan Program	84.038	3,894,680
Federal Pell Grant Program	84.063	768,529
Subtotal – College of Arts and Sciences, Schools of Law, Management, and Divinity		37,449,528
Total Student Financial Aid Cluster		51,456,393
Other Programs:		
College of Arts and Sciences, Schools of Law, Management, and Divinity:		
Department of Commerce	11.550	74,003
Institute of Museum and Library Sciences	45.301	31,448
Subtotal – Colleges of Arts and Sciences, Schools of Law, Management, and Divinity		105,451
Wake Forest University Health Sciences:		
Department of Education	84.116	44,914
Department of Education	84.902	59,501
Total Other Programs		209,866
Total Federal Award Expenditures		190,425,139

WAKE FOREST UNIVERSITY
Schedule of Expenditures of Federal and State Awards
Year ended June 30, 2006

Federal and state grantors/pass-through grantors/agencies, or cluster title	Federal CFDA Number	Expenditures
State Award Expenditures:		
Wake Forest University Health Sciences:		
NC Department of Health and Human Services	—	\$ 5,252,342
NC Department of Agriculture	—	26,976
North Carolina Aid to Medical Education	—	1,256,000
Board of Governors	—	684,608
State of NC Pass-through funds from:		
University of North Carolina at Chapel Hill	—	5,287,255
North Carolina Biotechnology Center	—	249,393
NC Health & Wellness Trust Fund	—	162,343
Other	—	90,159
Subtotal – Wake Forest University Health Sciences		<u>13,009,076</u>
College of Arts and Sciences, Schools of Law, Management, and Divinity:		
North Carolina Legislative Tuition Grant	—	1,956,600
North Carolina State Contractual Scholarship Fund	—	1,300,075
North Carolina Student Incentive Grant	—	12,250
Other	—	98,795
Subtotal – College of Arts and Sciences, Schools of Law, Management, Divinity		<u>3,367,720</u>
Total State Award Expenditures		<u>16,376,796</u>
Total Federal and State Award Expenditures		<u>\$ 206,801,935</u>

See accompanying notes to schedule of expenditures of Federal and State awards.

WAKE FOREST UNIVERSITY

Notes to Schedule of Expenditures of Federal and State Awards

Year ended June 30, 2006

(1) Basis of Presentation

The accompanying schedule of expenditures of federal and state awards includes all grants, contracts, and similar agreements entered into directly between Wake Forest University (the University) and agencies and departments of the federal and state governments and all subawards to the University by nonfederal organizations pursuant to federal and state grants, contracts and similar agreements and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

(2) Summary of Significant Accounting Policies for Federal and State Award Expenditures

Expenditures for certain federal student financial aid programs are recognized as incurred and include the federal share of students' Federal Supplemental Educational Opportunity Grant program grants and Federal Work Study program earnings, certain other federal financial assistance grants for students and administrative cost allowances, where applicable. Federal Pell grant awards are recognized as agency transactions and are not recorded as expenditures in the financial statements.

Expenditures for other federal awards of the University's academic and other divisions are determined using the cost accounting principles and procedures set forth in OMB Circular A-21, *Cost Principles for Educational Institutions*. Under these cost principles, certain expenditures are not allowable or are limited as to reimbursement.

Expenditures for non-financial aid awards include indirect costs, related primarily to facilities operation and maintenance and general, divisional and departmental administrative services, which are allocated to direct cost objectives (including federal awards) based on negotiated formulas commonly referred to as facilities and administrative cost rates. Facilities and administrative costs allocated to such awards for the year ended June 30, 2006 were based on provisional rates negotiated with the University's cognizant federal agency, the Department of Health and Human Services.

(3) Summary of Facilities and Administrative Costs and Administrative Cost Allowances - Governmental Sources

Facilities and administrative cost recoveries and administrative cost allowances for the University's academic and other divisions for the year ended June 30, 2006 are summarized as follows:

Federal	
Research and development	\$ 32,405,369
Student financial aid	254,759
Other	20,435
State	37,594
	<u>\$ 32,718,157</u>

WAKE FOREST UNIVERSITY

Notes to Schedule of Expenditures of Federal and State Awards

Year ended June 30, 2006

(4) Federal Student Financial Aid Loan Programs

The Federal Perkins, Health Professions Student Loan (HPSL) and the Primary Care Loan (PCL) Programs are administered directly by the University and balances and transactions relating to these programs are included in the University's financial statements. The balances of loans outstanding under the Federal Perkins, HPSL, and PCL programs were \$16,111,858, \$81,945, and \$350,751, respectively, as of June 30, 2006.

The University is responsible only for the performance of certain administrative duties with respect to the Federal Family Education Loan Programs and, accordingly, these loans are not included in its financial statements. It is not practicable to determine the balance of loans outstanding to students and former students of the University under these programs as of June 30, 2006.

(5) Subrecipients

Of the federal expenditures presented in the schedule, the University provided federal awards to subrecipients as follows:

Federal amount granting agency	Amount provided to subrecipients
National Institutes of Health	\$ 15,365,493
Agency for Healthcare Research & Quality	366,398
Center for Disease Control & Prevention	288,125
Department of Defense	606,172
Department of Justice	190,697
Department of Education	23,863
	\$ <u>16,840,748</u>



KPMG LLP
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Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Board of Trustees
Wake Forest University:

We have audited the financial statements of Wake Forest University as of and for the year ended June 30, 2006, and have issued our report thereon dated October 31, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Wake Forest University's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Wake Forest University's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management in separate letters dated October 12, 2006 and October 31, 2006.

This report is intended solely for the information and use of the audit committee of the board of trustees, management and federal and state awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 31, 2006



KPMG LLP
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Report on Compliance with Requirements Applicable to Each Major Program and on Internal Control over Compliance in Accordance with OMB Circular A-133

The Board of Trustees
Wake Forest University:

Compliance

We have audited the compliance of Wake Forest University with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that are applicable to its major federal program for the year ended June 30, 2006. Wake Forest University's major federal program is identified in the summary of auditors' results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Wake Forest University's management. Our responsibility is to express an opinion on Wake Forest University's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Wake Forest University's compliance with those requirements and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Wake Forest University's compliance with those requirements.

In our opinion, Wake Forest University complied, in all material respects, with the requirements referred to above that are applicable to its major federal program for the year ended June 30, 2006.

Internal Control Over Compliance

The management of Wake Forest University is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Wake Forest University's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133.

Our consideration of internal control over compliance would not necessarily disclose all matters in internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee of the board of trustees, management and federal and state awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

February 2, 2007

WAKE FOREST UNIVERSITY

Schedule of Findings and Questioned Costs

Year ended June 30, 2006

(1) Summary of Auditors' Results

- (a) The type of report issued on the financial statements: **Unqualified opinion**
- (b) Reportable conditions in internal control were disclosed by the audit of the financial statements: **No**
Material weaknesses: **None**
- (c) Noncompliance which is material to the financial statements: **None**
- (d) Reportable conditions in internal control over major programs: **None reported**
Material weaknesses: **None**
- (e) The type of report issued on compliance for major programs: **Unqualified opinion**
- (f) Any audit findings which are required to be reported under Section 0.510(a) of OMB Circular A-133: **No**
- (g) Major program: **Research and development**
- (h) Dollar threshold used to distinguish between Type A and Type B programs: **\$3,000,000**
- (i) Auditee qualified as a low-risk auditee under Section 0.530 of OMB Circular A-133: **Yes**

(2) Findings Relating to the Financial Statements Reported in Accordance with *Government Auditing Standards*: None

(3) Finding and Questioned Costs Relating to Federal Awards: None