

U.C. SAN DIEGO FOUNDATION

Financial Statements

June 30, 2005

(With Independent Auditors' Report Thereon)

U.C. SAN DIEGO FOUNDATION

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KPMG LLP
Suite 700
600 Anton Boulevard
Costa Mesa, CA 92626

Independent Auditors' Report

The Board of Trustees
U.C. San Diego Foundation:

We have audited the accompanying statement of net assets of the U.C. San Diego Foundation (the Foundation), a component unit of the University of California, as of June 30, 2005, and the related statements of revenues, expenses, and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Foundation'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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements present fairly, in all material respects, the financial position of the U.C. San Diego Foundation as of June 30, 2005, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 2 through 6 is not a required part of the financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

August 26, 2005

U.C. SAN DIEGO FOUNDATION

Management's Discussion and Analysis

June 30, 2005

The management of the U.C. San Diego Foundation (the Foundation) presents the following Management's Discussion and Analysis (MD&A) narrative overview and analysis of the financial activities of the Foundation for the fiscal year ended June 30, 2005, with comparative information for the year ended June 30, 2004. The purpose of this discussion is to enable the reader to identify and understand the significant issues and changes in the financial condition of the Foundation. The information presented here should be read in conjunction with accompanying audited financial statements and footnotes which begin on page 7. The financial statements, footnotes, and this discussion and analysis were created by management and are the responsibility of management.

Financial Highlights

Overview

The Foundation has continued to maintain strong financial results this year. The University of California, San Diego campus (UCSD) experienced its most successful year ever in terms of fund-raising totals. The Foundation was the primary receptacle of this success, and it, combined with positive investment returns, caused net assets to increase by \$37.6 million, or a 12% increase, for the fiscal year. As of June 30, 2005, over 74% of UCSD's "Imagine What's Next" \$1 billion seven-year comprehensive fund-raising campaign (the Campaign) has been raised through gifts and pledges, made to both the Foundation and to UCSD directly. The amount counted as raised thus far includes pledges pertaining to endowment, which, under generally accepted accounting principles, may not be recorded until the endowed gifts are actually received and their terms can be carried out; therefore endowed pledges are not reflected in the Foundation's financial statements, but are stated in a footnote.

The Foundation is pleased that the UCSD Cancer Center Foundation requested to merge with the Foundation as of June 30, 2005. This action was approved by both the Foundation's Board of Trustees and the Cancer Center Foundation Board, as well as various charitable regulatory agencies. The action was voluntary and accomplished efficiency in terms of record keeping and compliance with certain auditing and other requirements that had been enacted in the State of California effective for 2005. The effects of the merger are minimal on the Foundation's financial statements and are noted below as well as in a footnote.

U.C. SAN DIEGO FOUNDATION

Management's Discussion and Analysis

June 30, 2005

Presentation

The Foundation presents its financial report in accordance with Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis – for State and Local Governments* (GASB 34), which focuses the reader of the financial reports on the organization's overall financial condition, and changes in net assets and cash flow, taken as a whole.

Condensed Schedule of Net Assets

June 30, 2005 and 2004

(In thousands)

	2005	2004	Change	
			\$	%
Assets:				
Current assets	\$ 84,180	77,398	6,782	9%
Noncurrent assets	283,519	254,048	29,471	12%
Total assets	<u>367,699</u>	<u>331,446</u>	<u>36,253</u>	11%
Liabilities:				
Current liabilities	3,761	5,581	(1,820)	(33)%
Noncurrent liabilities	16,986	16,536	450	3%
Total liabilities	<u>20,747</u>	<u>22,117</u>	<u>(1,370)</u>	(6)%
Total net assets	<u>\$ 346,952</u>	<u>309,329</u>	<u>37,623</u>	12%
	2005	2004	Change	
			\$	%
Operating revenues/contributions	\$ 56,002	46,743	9,259	20%
Operating expenses	54,693	43,485	11,208	26%
Operating results	<u>1,309</u>	<u>3,258</u>	<u>(1,949)</u>	(60)%
Nonoperating income	21,701	20,812	889	4%
Additions to permanent endowments	14,613	7,313	7,300	100%
Change in net assets	<u>37,623</u>	<u>31,383</u>	<u>6,240</u>	20%
Net assets, beginning of year	<u>309,329</u>	<u>277,946</u>	<u>31,383</u>	11%
Net assets, end of year	<u>\$ 346,952</u>	<u>309,329</u>	<u>37,623</u>	12%

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Management's Discussion and Analysis

June 30, 2005

Condensed Schedule of Net Assets

Net assets serve as a useful indicator of an organization's financial health over time. Particular aspects of the Foundation's financial operations positively influenced the significant increase in net assets as of June 30, 2005 versus June 30, 2004.

Current assets of the Foundation, consisting primarily of cash, short-term investments, and pledges receivable expected to be collected within the next fiscal year, increased by nearly \$6.8 million during fiscal year 2005. A major component of this increase is attributable to the receipt of over \$12 million in gifts and pledge payments, most of which was intended for construction of new buildings, net of a decrease in the associated current portion of pledges receivable of \$4 million. A majority of these funds had not been requested by or transferred to the campus for expenditure and remained in the Foundation at fiscal year-end.

Noncurrent assets consist primarily of investment balances pertaining to endowment principal and life income funds (defined as irrevocable charitable remainder trusts for which the Foundation serves as trustee and all charitable gift annuity contracts issued by the Foundation), as well as the long-term portion of pledges receivable. Activities in the noncurrent assets category increased the Foundation's net assets by \$29.5 million, thereby accounting for 78% of the total growth in the net assets of the Foundation. Key elements of this increase were positive investment returns on the endowment producing in excess of \$14 million of unrealized appreciation and over \$14 million in new endowed gifts received during the fiscal year.

Total gross pledges receivable, before allowance and present value discounts, were \$71 million at June 30, 2005, a slight decrease from the prior year. Of this amount, \$15.5 million is due within the next year. An allowance for uncollectible pledges was maintained at 5% of gross pledges, as in the prior year, and balances due beyond one year have been discounted at an average annual rate of 4%. For the second year in a row, the Foundation received a significant new pledge in the amount of \$30 million to benefit and name the Skaggs School of Pharmacy and Pharmacological Sciences. Of this amount, \$20 million is endowed and will not be recorded until received; the balance of \$10 million was partially paid, and a \$4 million balance was recorded as a receivable on the Foundation's books as of fiscal year-end.

Total liabilities reflect a net decrease of \$1.4 million over the prior year's balance. This decrease is primarily due to the accounting effects of the merger with and absorption of the UCSD Cancer Center Foundation. Previously, the Foundation acted as the financial agent for the Cancer Center Foundation, and the activity and year-end balances in Cancer Center Foundation funds were reflected as a liability on the Foundation's financial statements. In accomplishing the merger, \$2.3 million was recognized as contributions and reduced the liability.

Condensed Schedule of Revenues, Expenses, and Changes in Net Assets

Net operating income was \$1.3 million in fiscal year 2005 versus \$3.2 million in fiscal 2004, or a decrease of approximately \$1.9 million. This is attributable to an increase in contribution revenue, offset by an even larger need for use of funds in the Foundation by the campus, as discussed below.

During fiscal year 2005, operations for the Foundation included the recognition of over \$56 million of contributions and other operating revenue, an increase of \$9.3 million or 20% over that of fiscal year 2004. This increase in operating revenue is attributable to several large new pledged contributions and outright cash gifts received during the year, including \$10 million of the \$30 million related to the Skaggs gift mentioned earlier.

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Management's Discussion and Analysis

June 30, 2005

Operating expenses were \$54.7 million during fiscal year 2005, an increase of \$11.2 million over that of fiscal year 2004. The primary component of the Foundation's operating expenses every year consists of grants made by the Foundation to the campus, in response to requests for use of funds by the intended campus beneficiaries. These grants are made for purposes that are in compliance with donor restrictions placed on contributions in support of the many UCSD programs and needs, including construction of new buildings, student aid, faculty research, and general departmental support. Changes in the amounts of grants made to campus annually occur in relation to campus needs for use of the funds or the timing of expenditures made on capital projects funded by contributions. The Foundation has had increasing levels of contributions over the course of the last few years, primarily attributable to the Campaign. This increased contribution activity, coupled with budgetary constraints experienced by the campus due to reductions in other types of resources, has increased our campus requests for use of funds in the Foundation.

Nonoperating results for fiscal year 2005 reflect net revenues of \$21.7 million, versus \$20.8 million for fiscal year 2004, an increase of less than \$1 million. Components of this change relate to the Foundation's investment activities and trust and life income funds liabilities. The investments of the Foundation generated cash yield during fiscal year 2005 of \$6.7 million, or \$900,000 less than fiscal 2004. Endowment investment returns produced by the Foundation's primary investment manager (The Treasurer of The Regents of the University of California) for fiscal year 2005 produced a total return of 10.2% for the fiscal year ended June 30, 2005, or over \$14 million in unrealized appreciation. This amount was less than the prior year by \$4 million. Nonoperating expenses associated with the change in the liability to trust and other life income beneficiaries resulted in income recognition of \$400,000 for fiscal year 2005, rather than expense of nearly \$4.2 million in fiscal 2004, or a reduction of nearly \$4.6 million in expense from fiscal year 2004. As of June 30, 2004 the Foundation eliminated recognition of any externally managed trusts, and the associated liability, the effects of which were recorded in this expense category.

Endowed gifts provided an additional \$14.6 million to the net assets of the Foundation during fiscal 2005, versus \$7.3 million in 2004. As noted above, recorded contributions for permanent endowments may include only outright endowed gifts and pledge payments (not the pledges themselves) and donor-designated contributions actually made to life income trusts and charitable gift annuities whose ultimate use will be for endowed purposes.

Using the Information in the Financial Report

The Foundation's financial statements can be found immediately following this discussion and analysis.

The Statement of Net Assets reports assets, liabilities, and net assets as of June 30, 2005. The balances are a reflection of activities that have occurred during fiscal year 2005 and come from transactions between assets and liabilities or from transactions in the statement of revenues, expenses, and changes in net assets. The balances are presented as either current (realizable within 12 months) or noncurrent in nature.

The Statement of Revenues, Expenses, and Changes in Net Assets presents the results of operations for the year ended June 30, 2005. Activities are reported as either operating or nonoperating, with gifts reported as operating revenue and investment results reported as nonoperating revenue. Both the statement of net assets and the statement of revenues, expenses, and changes in net assets are prepared using the accrual basis of accounting.

The remaining required statement is the Statement of Cash Flows showing the sources and uses of funds, in essence, accounting for the change in cash and cash equivalent balances for the reporting period.

U.C. SAN DIEGO FOUNDATION
Management's Discussion and Analysis
June 30, 2005

The notes provide additional information and more detail that is essential to a full understanding of the data provided in the financial statements. The notes to the financial statements can be found immediately following the financial statements.

U.C. SAN DIEGO FOUNDATION

Statement of Net Assets

June 30, 2005

Assets

Current assets:	
Cash and cash equivalents	\$ 1,214,466
Short-term investments	68,196,447
Pledges receivable, net of allowance for uncollectible receivables of \$775,801	14,740,218
Other assets	29,189
Total current assets	<u>84,180,320</u>
Noncurrent assets:	
Investments	250,880,097
Pledges receivable, net of allowance for uncollectible receivables of \$2,761,539 and discount of \$19,847,663	32,621,569
Other assets	17,593
Total noncurrent assets	<u>283,519,259</u>
Total assets	<u>367,699,579</u>

Liabilities and Net Assets

Current liabilities:	
Accounts payable	1,243,630
Agency funds	175,648
Liabilities to life beneficiaries	2,341,764
Total current liabilities	<u>3,761,042</u>
Noncurrent liabilities:	
Liabilities to life beneficiaries	15,511,748
Other noncurrent liabilities	1,474,335
Total noncurrent liabilities	<u>16,986,083</u>
Total liabilities	<u>20,747,125</u>
Net assets:	
Restricted:	
Nonexpendable:	
Endowments corpus	140,214,530
Annuity and life income funds	3,868,169
Expendable:	
Endowment spending	73,648,994
Annuity and life income funds	4,921,375
Funds functioning as endowments	9,713,122
Restricted gift funds	110,096,303
Unrestricted	4,489,961
Total net assets	<u>\$ 346,952,454</u>

See accompanying notes to financial statements.

U.C. SAN DIEGO FOUNDATION

Statement of Revenues, Expenses, and Changes in Net Assets

Year ended June 30, 2005

Operating revenues:	
Contributions	\$ 55,725,665
Other income	276,415
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Total operating revenues	56,002,080
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Operating expenses:	
Grants to campus for programs	53,759,995
Allowance for uncollectible receivables	392,929
Administrative and other operating expenses	540,002
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Total operating expenses	54,692,926
	<hr/>
Operating income	1,309,154
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Nonoperating income:	
Investment income	6,739,215
Net appreciation in fair value of investments	14,558,428
Change in calculated value of annuity and life income liabilities	403,587
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Total nonoperating income	21,701,230
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Income before additions to permanent endowments	23,010,384
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Additions to permanent endowments	14,613,262
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Change in net assets	37,623,646
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Net assets, beginning of year	309,328,808
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Net assets, end of year	\$ 346,952,454
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See accompanying notes to financial statements.

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Statement of Cash Flows

Year ended June 30, 2005

Cash flows from operating activities:	
Receipts from contributions	\$ 51,883,389
Payments to campus	(49,982,419)
Other payments	(5,386,621)
Net cash used by operating activities	<u>(3,485,651)</u>
Cash flows from noncapital financing activities:	
Private gifts for permanent endowments	<u>11,031,091</u>
Cash flows from investing activities:	
Proceeds from sale and maturities of investments	37,473,117
Purchases of investments	(50,624,593)
Investment income, net of investment expense	6,118,199
Net cash used by investing activities	<u>(7,033,277)</u>
Net increase in cash and cash equivalents	512,163
Cash and cash equivalents, beginning of year	<u>702,303</u>
Cash and cash equivalents, end of year	<u><u>\$ 1,214,466</u></u>
Reconciliation of operating income to net cash used by operating activities:	
Operating income	\$ 1,309,154
Adjustments to reconcile operating income to net cash used by operating activities:	
Noncash contributions	(6,490,892)
Allowance of uncollectible receivables	392,928
Changes in operating assets and liabilities:	
Pledges receivable	5,172,433
Other assets	(347,536)
Accounts payable	(919,481)
Annuities payable	(2,602,257)
Net cash used by operating activities	<u><u>\$ (3,485,651)</u></u>
See accompanying notes to financial statements.	
Supplemental noncash investing activities information:	
Gifts of marketable securities	\$ 10,260,368
Gifts of real or personal property	136,712

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

June 30, 2005

(1) Organization

The U.C. San Diego Foundation (the Foundation) is a California nonprofit corporation. The Foundation was formed in 1972 and is governed by a forty-three member Board of Trustees. The primary purposes of the Foundation are to be community advocates for the University of California, San Diego (UCSD) and to encourage charitable donations to provide financial support for the campus. As a public charity, the Foundation accepts donations to enhance the campus' many and varied teaching, research, and public service programs, as well as to support capital projects and other related campus improvements.

UCSD provides the resources necessary to cover the costs of the operation and administration of the Foundation's activities, including personnel, facilities, and administration. Per the University of California Policy and Guidelines on Campus Foundations, the Foundation's primary expenditures are related to grants made to the campus in support campus needs, in compliance with donor restrictions on gifts.

The Foundation's financial statements are discretely presented in the University of California's financial statements as a component unit.

(2) Summary of Significant Accounting Policies

A summary of the significant accounting policies applied in preparation of the accompanying financial statements are presented below:

(a) *Basis of Accounting*

The financial statements are prepared using the economic resource measurement focus and the accrual basis of accounting in accordance with the accounting principles generally accepted in the United States of America as promulgated by the Governmental Accounting Standards Board (GASB). Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. As a general rule, the effects of inter-fund activities have been eliminated from the Foundation's financial statements.

The U.C. San Diego Foundation adopted GASB Statement No. 40, *Deposit and Investment Risk Disclosures – an amendment of GASB Statement No. 3* for the year ended June 30, 2005. Statement No. 40 establishes additional disclosure requirements addressing common deposits and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, this statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in this statement also are required to be disclosed. Implementation of GASB Statement No. 40 had no effect on the Foundation's net assets or changes in net assets for the year ended June 30, 2005.

(b) *Classification of Current and Noncurrent Assets and Liabilities*

The Foundation considers assets to be current if, as part of its normal business operations, they are held as, or can be converted to, cash and be available for operating needs or payment of current liabilities within 12 months of the statement of net assets date. Similarly, liabilities are considered to be current if they can be expected, as part of the normal Foundation business operations, to be due

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Notes to Financial Statements

June 30, 2005

and paid within 12 months of the statement of net assets date. All other assets and liabilities are considered to be noncurrent.

(c) *Net Assets*

The Foundation's net assets are classified into the following net asset categories:

Restricted – nonexpendable: Net assets subject to externally imposed conditions that the Foundation retains the principal in perpetuity and only the earnings on the net assets are to be expended. These are original net corpus of true-donor-designated endowed funds and balances from life income funds that will ultimately be designated as endowed funds upon maturity.

Restricted – expendable: Net assets subject to externally imposed conditions that can be fulfilled by the actions of the Foundation or by the passage of time. These net assets include accumulated appreciation on the endowment funds and accumulated endowment spending allocations, balances from life income funds that will be designated as restricted expendable, funds functioning as endowments, and restricted expendable funds.

Unrestricted: All other categories of net assets.

(d) *Classification of Revenues and Expenses*

The Foundation considers operating revenues and expenses in the statement of revenues, expenses, and changes in net assets to be those revenues and expenses that result from exchange transactions or from other activities that are connected directly to the Foundation's primary functions. Exchange transactions include donations received by the Foundation, and the grants the Foundation makes to UCSD. Certain other transactions are reported as nonoperating revenues and expenses in accordance with GASB Statement No. 34. These nonoperating activities include the Foundation's noncapital financing activities and net investment income.

(e) *Cash and Cash Equivalents*

The Foundation's cash and cash equivalents are its cash in bank, money market accounts, and cash held in its UCSD agency account, which is used to deposit Foundation contribution receipts and make transfers to campus to expend in accordance with donor restrictions.

(f) *Investments*

Investments are carried at fair value. The basis of determining the fair value of investments is the readily determinable sales price or current exchange rate of the investments based on prices or quotations for over-the-counter markets such as the New York Stock Exchange or the National Association of Securities Dealers Automated Quotations. In the case of pooled funds or mutual funds, the fair value is determined by multiplying the number of units held in the pool by the price per unit share as quoted by the broker and/or investment manager. Investments in real estate are stated at a fair value as established by independent appraisals. The Foundation has one limited partnership which is stated at the discounted present value of the estimated cash flows to be generated over the remaining life of the partnership.

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

June 30, 2005

The net change in the fair value of investments consists of both realized and unrealized gain and loss on investments. Realized gains or losses resulting from specific transactions related to a single gift are accounted for in the specific gift fund. Gains or losses on the sale of components within any investment pool resulting from investment management decisions are attributed to the pool.

(g) *Endowments and Endowment Spending Policy*

The Foundation's endowed funds are invested in a unitized pool in accordance with the *Endowment Investment and Spending Policies and Guidelines* adopted by the Board of Trustees and the Uniform Management of Institutional Funds Act (UMIFA). The Foundation has adopted the total-return approach to managing its endowment and similar funds. Investment decisions are based on a long-term investment strategy, with objectives of maximizing the endowment portfolio's long-term total return (yield plus appreciation) through prudent acceptance of risk to enhance the future purchasing power and preservation of capital. The Foundation adjusted its endowment portfolio target mix during fiscal year 2005 to 85% equity holdings and 15% fixed-income holdings, with further refinements regarding the types of positions held within those general classes. The Foundation, through its Investment Committee, is in the process of asset selection and position acquisition or sale to achieve the target mix. The endowment earned a total return of 10.2% for the fiscal year ended June 30, 2005, net of investment fees.

Endowment spending is allocated to each endowment fund based on the spending rate set by Board policy, which gives consideration to total return, inflation, and the expendable income needs of the endowment fund holders. The endowment-spending rate for the fiscal year ended June 30, 2005 was set by the board of trustees at 4.60% of the unitized five-year average fair market value of a fund (calculated using the number of units owned by each endowment in the pool and the five-year average market value of a single unit in the pool), with 4.45% paid to the endowment funds and 0.15% used to recover endowment administration costs. Spending is distributed to the individual endowment funds monthly based on average units held by the endowment.

Under UMIFA and the total-return approach, annual endowment spending may be taken from both actual cash yield generated by the endowment investment portfolio and accumulated realized and unrealized appreciation in the portfolio. When the actual net cash income earned on the endowment investments (interest and dividends reduced by investment advisory fees) is less than the calculated spending, net realized and unrealized capital gains are appropriated. For the year ended June 30, 2005, endowment spending allocated to endowed funds pursuant to the Foundation's established spending rate was nearly \$8.1 million (net of administration costs of approximately \$254,000); approximately \$3.3 million of this amount represented appreciation or previously recognized gains that were appropriated to support the spending rate. For certain newer endowments, volatility in the investment market may have reduced their market value to an amount less than the original gift value. For these endowments, spending allocations are limited to a pro-rata share of actual cash investment earnings earned by that particular endowment fund.

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

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(h) *Earnings on Expendable Funds*

By UCSD policy, investment earnings on expendable gift fund balances held by the Foundation (and by UCSD) are not credited to individual funds. The first 2% earned on those funds are granted to the Vice Chancellor whose academic area is benefiting from the fund; the balance of any earnings is granted to UCSD for use by its External Relations division. Expenditure of the External Relations portion, in combination with other funding sources, is restricted to (1) paying the costs of operating the Foundation and (2) funding for UCSD's Campaign expenses. During the fiscal year ended June 30, 2005, the Foundation granted approximately \$1 million of earnings to UCSD under this policy compared to nearly \$884,000 in fiscal year 2004.

(i) *Charitable Remainder Trusts (CRTs)*

As of June 30, 2005, the Foundation was the trustee and sole beneficiary of 17 irrevocable charitable remainder trusts and one lead trust entered into with 18 separate donors. Each trust is a separate legal entity from the Foundation, and liability for trust payments to the life beneficiaries is limited to the assets of each trust. Trust investment assets are recorded in the financial statements in accordance with the classifications of other Foundation investments. Beneficiaries receive payments as specified in the trust agreements. The associated liability for these payments is recorded in the financial statements using recent life expectancy tables and certain other estimates in computing a present value of the liability. Upon the death of the life beneficiaries or at the end of the trust term, the trust is terminated, and the remaining assets are transferred to the appropriate Foundation fund and made available for the UCSD programs designated by the donor(s).

The Foundation is also the beneficiary of 13 charitable remainder unitrusts that are held and trustee by external entities. These trusts are not recorded in the financial statements and had an estimated net value (assets net of calculated liability to the donors) of approximately \$11 million (unaudited) as of June 30, 2005. Of this amount, \$9.8 million is attributable to one donor's externally administered trust for the benefit of the Jacobs School of Engineering.

(j) *Grants and Annuities Society – Charitable Gift Annuity*

The Foundation is licensed by the State of California Department of Insurance as a Grants and Annuities Society, and as such, may issue charitable gift annuity contracts (CGAs). CGAs are planned giving vehicles in which donors gift assets in exchange for fixed annuity payments over the life time of the annuitant(s). As of June 30, 2005, the Foundation had 90 contracts outstanding with 45 separate donors. The present value of the life annuities associated with these contracts was computed using recent life expectancy tables and certain estimated rates. Both the CGA assets, and the associated liabilities, are recorded in the financial statements separately and are not netted. Liability for payments to life income beneficiaries under CGA contracts is not limited to the CGA pool of assets, but is a liability of the Foundation itself. The net remainder from matured CGA contracts is used to fulfill the purposes set forth by the donor in the original annuity agreement.

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Notes to Financial Statements

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(k) Contributions and Pledges

Contributions to the Foundation are recorded at fair value when the eligibility requirements established by the donor have been satisfied. Pledges are written unconditional promises to make future contributions payments, and result in receivables that, if all eligibility requirements have been satisfied, are recognized as gift income at the discounted present value based on the expected future collections. Eligibility requirements for recognition of pledges receivable and the associated contribution revenue are satisfied when the Foundation can comply with both the purpose and time requirements imposed by donors. For endowed pledges, the purpose requirement (invest the principal) and the time requirement (hold intact in perpetuity) cannot be met until the gift is actually received. Therefore, pledges related to endowed funds are not recorded nor recognized as assets or gift income until payments are actually received.

(l) Administrative Fee on Contributions

Per UCSD policy, a flat 4% fee is assessed on all cash contributions (or those converted to cash, including contributions of stock) to the Foundation and to UCSD directly, which partially supports the operations of External Relations and the UCSD "Imagine What's Next" Campaign. The Foundation also assesses an administrative fee of 1% per annum on life income funds when they mature, to cover expenses associated with the management of those assets over time. The Foundation assessed fees under this policy totaling nearly \$3 million during fiscal year 2005.

(m) Merger of the UCSD Cancer Center Foundation

The UCSD Cancer Center Foundation requested to merge with the Foundation as of June 30, 2005. This action was approved by both the Foundation's Board of Trustees and the Cancer Center Foundation Board, as well as various charitable regulatory agencies. The action was voluntary and accomplished efficiency in terms of recording keeping and compliance with certain auditing and other legal requirements that had been enacted in the State of California effective for 2005. As a result of the merger, the Foundation recognized \$2.3 million in revenue as of June 30, 2005.

(n) Agency Affiliation with UCSD Alumni Association

The U.C. San Diego Foundation held and invested funds under an agency relationship with the UCSD Alumni Association during fiscal year 2005. The UCSD Alumni Association is a legally separate 501(c)(3) support group organized to support various UCSD activities primarily for UCSD alumni. The Foundation acts as the financial fiduciary for these funds, which are recorded on the financial statements as a current liability. The corresponding assets are included in investments. The Alumni Association's funds totaled approximately \$176,000 at June 30, 2005.

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Notes to Financial Statements

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(o) *Income Taxes*

The Foundation is an organization exempt from taxation under Section 501(c)(3) of the Internal Revenue Code and Section 23701d of the California Revenue and Taxation Code and is generally not subject to federal or state income taxes. However, the Foundation is subject to income taxes on any net income that is derived from a trade or business, regularly carried on, and not in furtherance of the purpose for which it is granted exemption. No income tax provision has been recorded as the net income, if any, from any unrelated trade or business, in the opinion of management, is not material to the basic financial statements taken as a whole.

(p) *Use of Estimates*

The preparation of financial statements in accordance 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 support and revenue and disbursements and expenses during the reporting period. Actual results could differ from those estimates.

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

June 30, 2005

(3) Cash, Cash Equivalents, and Investments

Cash, cash equivalents, and investments consist of the following as of June 30, 2005 (in thousands of dollars):

Cash and cash equivalents:	
Commercial banks and money market funds	\$ 443
University of California Short-Term Investment Pool (STIP)	771
Total cash and cash equivalents	1,214
Investments:	
Equity securities – domestic	175
Fixed income securities:	
U.S. Treasury notes	2,074
Other U.S. dollar denominated:	
U.S. agencies – asset-backed securities	2,967
Supranational/foreign	639
Commingled funds:	
Balanced funds (Regents GEP)	216,235
U.S. equity funds (Regents Russell 3000 Index)	11,126
Non-U.S. equity funds (Regents EAFE Index)	3,199
U.S. bond funds (Regents HIP, Fixed Income Fund, mutual fund)	10,566
Money market funds (Regents STIP)	67,194
Other:	
Private equity	1,244
Real estate	1,468
Limited partnership units	2,175
Other	15
Total investments	319,077
Total cash, cash equivalents, and investments	\$ 320,291
Current – cash and cash equivalents	\$ 1,214
Current – short term investments	68,196
Noncurrent – investments	250,881
	\$ 320,291

Cash and Investment Management

The Foundation deposits and maintains cash in various commercial banks and brokerage accounts to meet operating needs and transfers the excess funds as often as necessary to its primary investment accounts. At June 30, 2005, the Foundation had deposits in financial institutions with a bank balance of \$1,199,646 and a carrying value of \$1,214,466 of which none was covered by Federal Depository Insurance.

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

June 30, 2005

The Foundation invests primarily in the University of California commingled funds (UC pooled funds). A description of the funds used is as follows:

- **The General Endowment Pool (GEP)** is a balanced portfolio containing equity and fixed-income securities that provide diversification and economies of scale. The primary goal is to maximize long-term total return, growth of principal, and a growing payout stream to ensure that future funding for endowment-supported activities can be maintained. This fund is used as the core investment vehicle for the Foundation's endowed contributions.
- **The High Income Pool (HIP)** is essentially a bond portfolio emphasizing securities with higher yields. The primary investment goal of this pool is to produce a relatively high and stable level of income, with moderate growth. This pool is used alone, or in combination with other pools, where there are high payout requirements to funds or donors.
- **The Short-Term Investment Pool (STIP)** is a money market portfolio intended to allow fund participants to maximize return on their short-term cash balances by taking advantage of the economies of scale of investing in a larger pool. STIP emphasizes safety of principal and provides liquidity to meet campuses' cash flow requirements. Investments authorized by The Regents for the STIP include a broad spectrum of high-quality money market and fixed-income securities with a maximum maturity of 5-1/2 years. This fund is used by the Foundation as its core investment vehicle for expendable contributions.

The Foundation utilizes the following investment funds, as created by the UC Treasurer's Office and held in custody accounts at State Street Global Advisors, for its trusts and charitable gift annuity program:

- **The Russell 3000 Tobacco Free Index** is a U.S. equity fund, comprised of stocks in the Russell 3000 index, excluding tobacco companies. This fund is managed by State Street Global Advisors.
- **The EAFE Index** is a non-U.S. equity fund, comprised of the Morgan Stanley Capital Europe, Asia, Far East (EAFE) Index plus Canada, excluding U.S. This fund is managed by State Street Global Advisors.
- **The Fixed Income Pool** is a U.S. bond portfolio made up of U.S. government securities and mortgage-backed and U.S. corporate bonds. This pool is managed by the Treasurer of the University of California.

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

June 30, 2005

Change in the Fair Value of Investments

The change in the fair value of investment represents the difference between the fair value of investments at the beginning of the fiscal year and the end of the fiscal year, taking into consideration investment purchases, sales, and redemptions. The calculation of realized gains and losses on the sale of investments is independent of the calculation of the net change in the fair value of investments. Realized gains and losses on investments that had been held more than one fiscal year and sold in the current year were included as a change in the fair value of investments reported in the current year and include transactions arising from sale of contributed assets and liquidation of investment accounts during the year. The components of the change in fair value of investments (in thousands of dollars) are as follows:

Change in unrealized appreciation on investments	\$	14,356
Realized gain on investments, net		<u>202</u>
Change in fair value of investments	\$	<u><u>14,558</u></u>

Investment Risk Factors

There are many factors that can affect the value of investments. Some, such as custodial risk, concentration of credit risk, and foreign currency risk may affect both equity and fixed-income securities. Equity securities respond to such factors as economic conditions, individual company earnings performance, and market liquidity, while fixed income securities are particularly sensitive to credit risks and changes in interest rates. The Foundation has established investment policies to provide the basis for the management of a prudent investment program appropriate to the particular fund type.

Credit Risk

Fixed-income securities are subject to credit risk, which is the risk that a bond issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause prices to decline. The circumstances may arise due to a variety of factors such as financial weakness, bankruptcy, litigation, and/or adverse political developments. A bond's credit quality is an assessment of the issuer's ability to pay interest on the bond, and ultimately, to pay the principal. Credit quality is evaluated by one of the independent bond rating agencies such as Moody's Investors Service or Standard and Poor's. The lower the rating, the greater the chance that the bond issuer will default or fail to meet its payment obligations. Generally, the lower a bond's credit rating, the higher its yield should be to compensate for the additional risk.

Certain fixed income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk. The Foundation's investment in the University's STIP and HIP is considered to be an investment in an external investment pool and are "unrated." Similarly, the Fixed-Income Pool, managed by the Treasurer of the Regents, is an external commingled pool and also is "unrated."

U.C. SAN DIEGO FOUNDATION

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June 30, 2005

The Foundation holds individual bonds in its charitable gift annuity reserve program. To mitigate credit risk in this portfolio, the Foundation's investment policy allows only the purchase of U.S. Treasuries of any maturity and up to 40% of the reserve account may include securities issued or guaranteed by the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), the Government National Mortgage Association (GNMA or Ginnie Mae), Federal National Mortgage Association (FNMA of Fannie Mae). In addition, the Foundation manages a separately invested permanent endowment created in 1994 under the auspices of the Debt for Education program sponsored by the government of Mexico in which the Foundation, in an agreement with the Mexican government, will maintain a trust account (currently with Banamex) and the endowment will be invested in U.S.-denominated Mexican domestic fixed-income securities. The income from the bond will be repatriated back to the Foundation to support fellowships. The Foundation is exposed to credit risk for the amount of the investments in this Mexican account in the event of nonperformance by the other parties to the investment transactions. A formal investment policy statement to address GASB 40 standards regarding credit risk, interest rate, and custodial risk for the fixed-income holdings is under development.

The credit risk profile for fixed income securities at June 30, 2005 is as follows (in thousands of dollars):

		<u>Credit rating</u>
Fixed-income securities:		
U.S. government guaranteed	\$ 2,074	no risk
U.S. agencies	2,967	AAA
Supranational	<u>639</u>	BBB
	5,680	
Commingled funds:		
U.S. bond funds	10,566	not rated
Money market funds	<u>67,194</u>	not rated
	<u>77,760</u>	
Total fixed-income securities	\$ <u><u>83,440</u></u>	

Custodial Credit Risk – Deposits and Investments

Custodial credit risk for deposits and investments is the risk that in the event of the failure of the custodian, the Foundation may not be able to recover the value of investment securities that are in the possession of an outside party.

The Board of Trustees of the U.C. San Diego Foundation, as the governing board, is responsible for oversight of the Foundation's investments. Pursuant to The Regents' Policy on Campus Foundations, the Foundation's Board of Trustees has the authority to oversee the management of its investments directly, or utilize the services and investment vehicles offered by the U.C. Regents' Treasurer's Office. The Foundation Board has chosen to primarily use the various pooled investment vehicles managed by the U.C. Regents' Treasurer as its core investment for the endowment and expendable funds, and its trusts. Although it does not have a specific policy addressing custodial risk, substantially all of the Foundation's investment assets (97%) are invested with the various investment pools managed by the Treasurer of the University of California. These pools are considered to be investments in external pools and are not

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

June 30, 2005

exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form. The Foundation has investment in the GEP, HIP, and STIP, as described earlier. Similarly, the investment accounts held at State Street Global Advisors (EAFE Index, Russell 3000 Index and Fixed Income Fund), are also externally managed pools, and the assets are held in custody or trust and would not be available to State Street's creditors because they are excluded from the assets of the custodian.

The Foundation minimizes cash balances by sweeping available balances into investment accounts on a regular basis. The majority of the cash balance not invested is maintained in the Regents STIP fund. The STIP fund is managed by the Treasurer of The Regents. The Regents are responsible for managing the University's investments and establishing policy, which is carried out by the Treasurer. STIP in the cash equivalent category is considered to be an external investment pool and therefore is not subject to deposit custodial credit risk. Remaining cash is maintained in accounts that are established as segregated trusts, protected against any creditors of the bank, and in money market mutual funds. Although they are not insured and are uncollateralized, these accounts are held in the name of the Foundation. Accounts may also be maintained at FDIC insured banking institutions up to the insured level. There is no custodial credit risk or foreign currency risk associated with balances maintained at the banks' trust departments and investment in the STIP. The Foundation did not have a formal policy regarding custodial credit for deposits at June 30, 2005.

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The Foundation does have custodial risk related to \$100,000 of a publicly traded REIT equity security that is not registered in the name of the Foundation, but is registered in the name of the Regents of the University of California. This asset is maintained on the books of The Regents' Treasurer's Office as separate ownership due to the Foundation. An investment policy relating to custodial risk is under development for this investment.

The custodial credit risk profile for fixed income securities at June 30, 2005 is as follows (in thousands of dollars):

Not exposed to custodial risk:

Investment type:

Equity securities:

Domestic

\$ 74

Fixed-income securities:

U.S. government guaranteed

2,074

Other U.S. dollar denominated

U.S. agencies

2,967

Supranational/foreign

639

Total not exposed to custodial risk

5,754

Exposed to custodial risk

Investment type:

Equity securities – domestic

101

Total exposed to custodial risk

101

Not subject to custodial risk:

Cash and cash equivalents

1,214

Commingled funds:

Balanced funds (Regents GEP)

216,235

U.S. equity funds (Regents Russell 3000 Index)

11,126

Non-U.S. equity funds (Regents EAFE Index)

3,199

U.S. bond funds (Regents HIP, Fixed Income Fund, mutual fund)

10,566

Money market funds (Regents STIP)

67,194

Other

Private equity

1,244

Real estate

1,468

Limited partnership units

2,175

Other

15

314,436

Total cash and investments

\$ 320,291

Concentration of Credit Risk

Concentration of credit risk is the risk of loss associated with a lack of diversification of having too much invested in a few individual issuers, thereby exposing the organization to greater risks resulting from

U.C. SAN DIEGO FOUNDATION

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June 30, 2005

adverse economic, political, regulatory, geographic, or credit developments. Securities issued or explicitly guaranteed by the U.S. government, mutual funds, external investment pools, and other pooled investments are excluded from this review. Investments in the various investment pools managed by the Treasurer of The Regents are external investment pools and are not subject to concentration of credit risk. There is no concentration of any single individual issuer of equity or non-U.S. government fixed income securities that comprise more than five percent of total investments. The Foundation does not have a policy regarding concentration of credit risk.

Interest Rate Risk

Interest rate risk is the risk that the value of fixed-income securities will decline because of rising interest rates. The prices of fixed-income securities with a longer time to maturity tend to be more sensitive to changes in interest rates and, therefore, more volatile than those with shorter maturities. In accordance with its CGA reserve account investment policy, the Foundation monitors the weighted average maturity of its investment portfolio and analysis of cash flow demand. The operating practice is to ladder the maturities of the fixed-income securities with staggered maturity dates from one to ten years and uses the weighted average maturity method to identify and manage interest rate risk. The Foundation does not have an interest rate risk policy.

The interest rate risk profile for fixed income securities at June 30, 2005 is as follows (in thousands):

	Fair value June 30, 2005	Weighted average maturity
Fixed income securities:		
U.S. government guaranteed	\$ 2,074	4.02 years
Total U.S. government guaranteed	2,074	
Other U.S. dollar denominated:		
U.S. agencies – asset-backed securities	2,967	3.82 years
Supranational/foreign	639	3.13 years
Total other U.S. dollar denominated	3,606	
Commingled funds:		
U.S. bond funds: Not rated	10,566	
Money market funds: Not rated	67,194	
Total commingled funds	77,760	
Total fixed income	\$ 83,440	

Foreign Currency Risk

Foreign currency risk is the possibility that changes in exchange rates between the U.S. dollar and foreign currencies could adversely affect a deposit or investment's fair value. The Foundation, via its investment in the Regents' STIP fund, has no exposure to foreign currency risk. The Foundation's endowment asset

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

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allocation policy includes an allocation to non-U.S. equities. This exposure is obtained through investment in the GEP which has an internal allocation to non-U.S. securities. The Foundation also had foreign currency exposure through its investment in the Regents' EAFE Index due to the foreign currency denominated investments in this fund. Under the Foundation's investment policy, there is no provision to purchase individual foreign-denominated securities.

(4) Pledges Receivable

At June 30, 2005, unpaid pledges for expendable funds were designated for the following UCSD projects:

Rady School of Management	\$ 25,380,738
Sulpizio Family Cardiovascular Center	12,788,191
Leichtag Biomedical Research	11,600,000
Skaggs School of Pharmacy	4,000,000
Swartz Center for Computational Neuroscience	3,175,500
W.J. von Liebig Center for Entrepreneurism & Technology	3,100,000
California Institute for Telecommunications and Information Technology	1,450,000
Unrestricted Chancellor's Discretionary Use	1,000,000
Other	<u>8,252,361</u>
Total gross pledges	70,746,790
Less allowance for uncollectible pledges	(3,537,340)
Less discount to present value	<u>(19,847,663)</u>
Total unpaid pledges (net of allowances and discounts)	<u><u>\$ 47,361,787</u></u>

These gross pledges are expected to be collected in future years, as follows:

Payments through June 30:	
2006	\$ 15,516,020
2007	5,285,394
2008	7,490,428
2009	3,885,448
2010	3,197,000
Thereafter	<u>35,372,500</u>
	<u><u>\$ 70,746,790</u></u>

An allowance for uncollectible pledges has been established at 5% of the total undiscounted unpaid pledges. Pledge payments extending beyond one year are discounted to recognize the present value of the future cash flows and have been discounted at a rate of 4%. Pledges receivable from eighteen donors accounted for approximately 91% of the gross pledges receivable balance at June 30, 2005.

At June 30, 2005, pledge balances related to endowed funds totaling approximately \$45.3 million (unaudited) have not been recorded by the Foundation as assets, since the eligibility requirements as stated in note 2(k) have not been satisfied.

U.C. SAN DIEGO FOUNDATION

Notes to Financial Statements

June 30, 2005

(5) Grants to Campus for Programs

The primary purpose of the Foundation is to receive donations for the support of UC San Diego. During the year ended June 30, 2005, the Foundation made transfers to the campus in compliance with donor restrictions for the purposes noted below. Ninety areas of the campus were the beneficiaries of these transfers.

Capital Project Construction	\$ 20,347,949
General Departmental Support	17,689,934
Research and Related Faculty Support	7,176,535
Student Aid (undergraduate and graduate)	4,106,465
Administrative Fees on Contributions Remitted to Campus	2,681,253
Interest Earnings Granted to Campus	918,333
Grants to Other Areas of Campus	839,526
	<u>\$ 53,759,995</u>

(6) Related-Party Transactions

During the year ended June 30, 2005, approximately \$18.1 million in outright cash gifts (or approximately 33% of total cash contributions) was received from members of the Board and Board-affiliated corporations and organizations. Approximately \$10 million in pledges receivable (or approximately 14% of total gross pledges receivable) are from members of the Board and Board-affiliated organizations as of June 30, 2005.

(7) Oversight by the University of California

The Foundation is subject to the policies and procedures of The Regents of the University of California (The Regents). All contributions to the Foundation ultimately benefit UCSD. Accordingly, the Foundation is considered a governmental not-for-profit organization subject to reporting under the GASB, and its result is reported as a component unit of the campus and The Regents. The Regents established a *Policy and Administrative Guidelines on Campus Foundations*, which requires that the Foundation transfer contributed expendable funds and endowment spending to The Regents for ultimate expenditure. These transfers amounted to approximately \$54 million for the year ended June 30, 2005. Contributions that are made directly to The Regents for the benefit of UCSD are not recorded by the Foundation and are not reflected in the accompanying financial statements; contributions made to UCSD are reflected in the financial statements of the University.

(8) Subsequent Events

The Foundation was notified of the passing of a donor who has bequeathed his entire trust and estate, valued at approximately \$30 million, to the U.C. San Diego Foundation. The donor's intention was to create an endowed fund to support cancer research. The Treasurer of the University of California was named Trustee and Executor. The trust and estate assets consist primarily of significant individual securities and income generating real properties located in San Diego County. The Treasurer has engaged the services of Wachovia Bank to act as its agent in overseeing the trust and estate assets and their liquidation. The Foundation records distributions from this trust and estate as they are received as

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contribution revenue. As of June 30, 2005, the Foundation had received \$2 million from the trust, as a principal contribution to the endowed fund. Subsequent to June 30, 2005, the Foundation received an additional \$9 million distribution from the trust as an addition to the endowed fund. It is anticipated that the full distribution of the trust and estate assets will be completed by June 30, 2007.



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Independent Auditors' Report on Compliance

The Board of Trustees
U.C. San Diego Foundation:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the accompanying statement of net assets of the U.C. San Diego Foundation (the Foundation) as of June 30, 2005, and the related statements of revenues, expenses, and changes in net assets and cash flows for the year then ended, and have issued our report thereon, dated August 26, 2005.

In compliance with requirement IV.C.2 of the University of California Administrative Guidelines for Campus Foundations (the Administrative Guidelines) dated February 12, 2004, we report that, in connection with our audit, nothing came to our attention that caused us to believe that the Foundation was not in compliance with the Regents' Policy on Campus Foundations dated September 15, 1995 and the Administrative Guidelines. However, it should be noted that our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the board of trustees, management of the Foundation, the Board of Regents, and management of the University of California, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

August 26, 2005