

Board of Trust, The Vanderbilt University:

We have audited the accompanying consolidated statements of financial position of The Vanderbilt University (the University) as of June 30, 2006 and 2005, and the related consolidated statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the 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, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Vanderbilt University as of June 30, 2006 and 2005, and the changes in its net assets and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As described in note 16 to the financial statements, on June 30, 2006, the University adopted Financial Accounting Standards Board Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*.

KPMG LLP

September 5, 2006,

except as to note 5 which is as of September 25, 2006



As of June 30, 2006 and 2005 (in thousands)

	2006	2005
ASSETS		
Cash and cash equivalents	\$ 511,573	\$ 217,697
Collateral under security lending agreements	271,353	324,757
Accounts receivable	257,567	230,262
Prepaid expenses and other assets	109,946	80,118
Contributions receivable	80,608	84,381
Student loans receivable	34,461	35,117
Investments	3,277,053	3,188,638
Property, plant, and equipment	1,457,159	1,365,177
Interest in trusts held by others	42,936	42,782
Total assets	\$ 6,042,656	\$ 5,568,929
LIABILITIES		
Accounts payable and accrued liabilities	\$ 216,917	\$ 260,093
Accrued payroll and withholdings	136,808	137,871
Payable under security lending agreements	271,353	324,757
Deferred revenue	52,067	48,091
Commercial paper	144,830	5,500
Actuarial liability for self-insurance	77,396	70,464
Actuarial liability for annuities payable	39,746	38,542
Government advances for student loans	16,007	15,781
Long-term debt and capital leases	761,787	780,399
Total liabilities	1,716,911	1,681,498
NET ASSETS		
Unrestricted	3,445,162	3,044,386
Temporarily restricted	155,755	175,043
Permanently restricted	724,828	668,002
Total net assets	4,325,745	3,887,431
Total liabilities and net assets	\$ 6,042,656	\$ 5,568,929

The accompanying notes are an integral part of the consolidated financial statements.



Consolidated Statements of Activities

Years Ended June 30, 2006 and 2005 (in thousands)

CHANGES IN UNRESTRICTED NET ASSETS

REVENUES

Tuition and educational fees, net	\$ 188,166	\$ 180,136
Government grants and contracts	277,839	257,241
Facilities and administrative costs recovery	100,081	92,892
Private gifts, grants, and contracts	68,578	61,919
Endowment distributions	109,270	103,849
Investment income	28,256	28,564
Health care services	1,577,841	1,387,235
Room, board, and other auxiliary services, net	75,565	73,248
Other sources	38,626	27,507
Net assets released from restrictions	17,841	16,931

Total revenues**2,482,063** **2,229,522**

EXPENSES

Instruction	334,308	298,823
Research	321,035	298,996
Health care services	1,475,234	1,301,615
Academic support	100,503	97,390
Institutional support	54,128	57,403
Student services	24,596	24,936
Public service	23,869	28,056
Room, board, and other auxiliary services	94,372	91,030

Total expenses**2,428,045** **2,198,249****Change in unrestricted net assets from operating activity****54,018** **31,273**

OTHER UNRESTRICTED ACTIVITY

Gifts and contributions for plant	5,212	7,090
Net assets released from restrictions for plant	29,312	39,458
Donor designation changes	(1,600)	(521)
Change in endowment appreciation, net of distributions	262,583	292,307
Cumulative effect of a change in accounting principle	(17,540)	—
Other, including change in fair value of interest rate swap agreements	68,791	(40,934)

Change in unrestricted net assets from other unrestricted activity**346,758** **297,400****Increase in unrestricted net assets****400,776** **328,673****CHANGES IN TEMPORARILY RESTRICTED NET ASSETS**

Contributions and other	5,441	3,922
Donor designation changes	(5,506)	(19,707)
Net gain on contributions receivable	6,935	5,864
Endowment distributions	2,816	2,545
Investment gains	18,179	16,826
Net assets released from restrictions	(47,153)	(56,389)

Decrease in temporarily restricted net assets**(19,288)** **(46,939)****CHANGES IN PERMANENTLY RESTRICTED NET ASSETS**

Contributions and other	45,908	15,725
Donor designation changes	7,106	20,228
Endowment distributions	794	252
Investment gains	3,018	10,116

Increase in permanently restricted net assets**56,826** **46,321****Increase in total net assets****\$ 438,314** **\$ 328,055****Net assets at beginning of year****3,887,431** **3,559,376****Net assets at end of year****\$ 4,325,745** **\$ 3,887,431**

Operating

Non-operating



Years Ended June 30, 2006 and 2005 (in thousands)

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Increase in total net assets	\$ 438,314	\$ 328,055
Adjustments to reconcile increase in total net assets to net cash provided by operating activities:		
Non-operating changes in net assets		
Gifts for plant and endowment	(58,819)	(53,396)
Net realized investment gains	(247,455)	(208,906)
Non-cash changes in net assets		
Net increase in unrealized appreciation	(108,005)	(188,380)
Gifts of securities other than for plant and endowment	(19,398)	(14,367)
Depreciation and amortization	120,980	105,600
Present value adjustment on annuities payable	1,204	945
Present value adjustment on self-insurance	6,932	11,873
Net (increase) decrease in interest in trusts held by others	(154)	2,729
Amortization of bond discounts and premiums	(4,740)	(890)
Net (increase) decrease in fair value of interest rate swap agreements	(68,875)	39,283
Cumulative effect of a change in accounting principle	17,540	—
Change in operating assets and liabilities		
Decrease (increase) in:		
Accounts receivable	(27,305)	(1,956)
Prepaid expenses and other assets	(6,236)	(4,544)
Contributions receivable	3,773	18,784
Increase (decrease) in:		
Non-construction accounts payable and accrued liabilities	(15,411)	28,511
Accrued payroll and withholdings	(1,063)	20,655
Deferred revenue	3,976	11,903
Net cash provided by operating activities	35,258	95,899
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of investments	(1,593,061)	(3,733,318)
Proceeds from the sale of investments	1,879,504	3,654,137
Acquisition of property, plant, and equipment	(219,247)	(221,880)
Disposal of property, plant, and equipment	6,285	1,242
Student loans disbursed	(5,633)	(6,521)
Principal collected on student loans	6,289	5,826
Net cash provided by (used in) investing activities	74,137	(300,514)
CASH FLOWS FROM FINANCING ACTIVITIES		
Gifts for plant and endowment	58,819	53,396
(Decrease) increase in construction-related payables	(22)	4,663
Increase in government advances for student loans	226	322
Proceeds from the issuance of debt	140,776	482,860
Payments to retire or defease debt	(15,318)	(305,871)
Net cash provided by financing activities	184,481	235,370
Net increase in cash and cash equivalents	\$ 293,876	\$ 30,755
Cash and cash equivalents at beginning of year	217,697	186,942
Cash and cash equivalents at end of year	\$ 511,573	\$ 217,697

The accompanying notes are an integral part of the consolidated financial statements.

Notes to the Consolidated Financial Statements

1. Organization

The Vanderbilt University (the University) is a privately endowed, coeducational, not-for-profit, nonsectarian institution located in Nashville, Tennessee. Founded in 1873, the University owns and operates educational and research facilities as well as a health care system. The University provides educational services to approximately 6,400 undergraduate and 5,100 graduate and professional students enrolled in its ten schools and colleges. The Chancellor and the Board of Trust, the governing board of the University, have oversight responsibility for all of the University's financial affairs.

These consolidated financial statements include the accounts of all entities in which the University has a significant financial interest and over which the University has control, including its hospitals and clinics. All significant intercompany accounts and transactions have been eliminated in consolidation.

2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements of the University have been prepared on the accrual basis in accordance with accounting principles generally accepted in the United States of America.

Based on the existence or absence of donor-imposed restrictions, the University classifies resources into three categories: unrestricted, temporarily restricted, and permanently restricted net assets.

Unrestricted net assets are free of donor-imposed restrictions. All revenues, gains, and losses that are not temporarily or permanently restricted by donors are included in this classification. All expenditures are reported in the unrestricted class of net assets, since the use of restricted contributions in accordance with donors' stipulations results in the release of the restriction.

Temporarily restricted net assets are limited as to use by donor-imposed stipulations that expire with the passage of time or that can be satisfied by action of the University. These net assets may include unconditional pledges, split-interest agreements, and interest in trusts held by others.

Permanently restricted net assets are amounts required by donors to be held in perpetuity. These net assets may include unconditional pledges, true endowment, split-interest agreements, and interest in trusts held by others.

Expirations of temporary restrictions on net assets, i.e., the passage of time and/or fulfilling donor-imposed stipulations, are reported as *net assets released from restrictions* between the applicable classes of net assets in the Consolidated Statements of Activities.

Cash and Cash Equivalents

Cash and cash equivalents, maturing in 90 days or less at date of purchase, are reported at fair value.

Investments

Investments are reported at fair value, based primarily on market quotes, except for certain real estate and mortgages that are stated at cost. Fair values for certain alternative investments (mainly investments in limited partnerships) primarily are based on estimates reported by fund managers where a ready market for the investments does not exist. The estimated values are reviewed and evaluated by the University.

The University has significant exposure to a number of risks including interest rate, market, and credit risks for both marketable and non-marketable securities. Due to the level of risk exposure, it is possible that near-term valuation changes for investment securities may occur to an extent that could materially affect the amounts reported in the University's financial statements.

Purchases and sales of securities are recorded on the trade dates, and realized gains and losses are determined on the basis of the average historical cost of the securities sold. Net receivables and payables arising from unsettled trades by investment managers are reported as a component of investments.

All true endowment investments and long-term net assets functioning as endowment are managed in a pool, unless special considerations or donor stipulations require that they be held separately.

Gains and losses on investments generally are reported as increases or decreases in unrestricted net assets unless explicit donor stipulations or law restrict their use.



Endowment Distribution Policy

The University employs a total return policy that establishes the amount of endowment income distributed to support current operational needs. This policy is designed to reduce the impact of capital market fluctuations on operational programs and increase the amount of return that is reinvested in the corpus of funds in order to enhance its long-term value.

Under this policy, endowment income distributions are based on 4.5% of the previous three years' average calendar year-end market values. Actual endowment return earned in excess of distributions under this policy is reinvested as part of the University's managed endowment and is reported as a non-operating item in the Consolidated Statements of Activities. For years where actual endowment return is less than distributions under the policy, the shortfall is covered by realized returns from prior years.

Additionally, the Board of Trust has authorized the use of previously reinvested income, realized capital gains, and principal related to unrestricted funds functioning as endowment for special transinstitutional academic development initiatives. Endowment distributions reported in the Consolidated Statements of Activities include both (a) distributions to support current operational needs under the policy as previously described and (b) the aforementioned supplemental endowment distributions for special academic initiatives to the extent operating expenditures have been incurred.

The supplemental use of unrestricted funds functioning as endowment to invest in capital needs of special academic initiatives is not reported as endowment distributions in the Consolidated Statements of Activities.

Other Financial Instruments

Recorded amounts for receivables, prepaid expenses and other assets, and accounts payable and accrued expenses approximate fair value.

Using market quotations for similar issues or borrowings, the University evaluates the estimated fair value of its fixed-rate long-term indebtedness relative to carrying value. Principal balances for fixed-rate debt are reported at carrying value, which is substantially equivalent to estimated fair value.

The University employs derivatives, primarily interest rate swap agreements, to manage market risk associated with outstanding variable-rate debt. Derivative financial instruments are reported at

fair value with any resulting gain or loss recognized as a non-operating item in the Consolidated Statements of Activities. Periodic net cash settlement amounts with counterparties are accounted for as adjustments to interest expense on the related debt.

Parties to interest rate swap agreements are subject to market risk for changes in interest rates as well as risk of credit loss in the event of nonperformance by the counterparty. The University deals only with high-quality counterparties that meet rating criteria for financial stability and credit worthiness. Additionally, the University requires the posting of collateral when amounts subject to credit risk under swap arrangements exceed specified levels.

University management also approves strategic use of derivatives by external investment managers to manage market risks. The most common strategies engaged by such managers are futures contracts, short sales, and hedges against currency translation risk for investments denominated in other than U.S. dollars. These derivative instruments are recorded at their respective fair values.

Through an agreement with its primary investment custodian, the University participates in security lending to brokers. For pledged cash and cash equivalents collateral under the control of the University, a short-term asset and liability are recorded representing the market value of such collateral.

Split-Interest Agreements and Interest in Trusts Held by Others

The University's split-interest agreements with donors consist primarily of irrevocable charitable remainder trusts, charitable gift annuities, and life income funds for which the University serves as trustee. Assets held in these trusts are included in investments. Contribution revenue is recognized at the dates the trusts are established, net of the liabilities for the present value of the estimated future payments to be made to the donors and/or other beneficiaries. Annually, the University records the change in value of split interest agreements by marking to market the assets that are associated with each trust and recalculating the liability for the present value of the estimated future payments to be made to the donors and/or other beneficiaries.

The University also is the beneficiary of certain trusts held and administered by others. The University's share of these trust assets is recorded at fair value as interest in trusts held by others with carrying values adjusted annually for changes in fair value.

Property, Plant, and Equipment

Purchased property, plant, and equipment are recorded at cost, including, where appropriate, capitalized interest. Donated assets are recorded at fair market value at the date of donation. Additions to the library collection are expensed at the time of purchase.

Depreciation is calculated by the straight-line method at rates estimated to allocate the cost of various classes of assets over their estimated useful lives. Equipment is removed from the accounting records at the time of disposal.

Conditional asset retirement obligations related to legal requirements to perform certain future activities related to the retirement, disposal, or abandonment of assets are accrued utilizing site-specific surveys to estimate the net present value for applicable future costs, e.g., asbestos abatement or removal.

The University reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment charge is recognized when the fair value of the asset or group of assets is less than the carrying value.

Revenue Recognition

The University's revenue recognition policies are as follows:

Tuition and educational fees, net—Student tuition and educational fees are recorded as revenues during the year the related academic services are rendered. Student tuition and educational fees received in advance of services to be rendered are recorded as deferred revenue. Financial aid provided by the University for tuition and educational fees is reflected as a reduction of tuition and educational fees. Financial aid does not include payments made to students for services rendered to the University.

Government grants and contracts—Revenues from government grants and contracts are recognized when allowable expenditures are incurred under such agreements.

Facilities and administrative (F&A) costs recovery—F&A costs recovery, historically referred to as indirect cost recovery, is recognized as revenue and represents reimbursement, primarily from the federal government, of F&A costs on research grants. The federal F&A costs recovery rate for on-

campus research was 52.0% in fiscal 2006. This rate increases to 53.0% in fiscal 2007 and 53.5% in fiscal 2008.

Health care services—Health care services revenue is reported at established rates, net of contractual adjustments and charity services. Third party contractual revenue adjustments under governmental reimbursement programs are accrued on an estimated basis in the period the related services are rendered. The estimated amounts are adjusted to actual during the year that final settlement is determined by the fiscal intermediary for each program. Health care services revenue includes that of Vanderbilt University Hospitals and Clinics, Vanderbilt Medical Group, Vanderbilt Health Services, Inc., and other activities directed toward the purpose of providing health care services to the community.

Contributions

Unconditional promises to give (pledges) are recognized as contribution revenue when the donor's commitment is received. Conditional promises (primarily bequest intentions) are not recorded until donor stipulations are substantially met.

Unconditional promises to give, with payments due to the University in future periods, are recorded as increases in temporarily restricted or permanently restricted net assets at the estimated present value of future cash flows, net of an allowance for estimated uncollectible promises. Amortization of the discount is recorded as additional contributions in the appropriate net asset class. Allowance is made for uncollectible contributions receivable based upon management's analysis of past collection experience and other judgmental factors.

Contributions with donor-imposed restrictions are recorded as unrestricted revenue if those restrictions are met in the same reporting period. Otherwise, contributions with donor-imposed restrictions are recorded as increases in temporarily restricted or permanently restricted net assets, depending on the nature of the restriction.

Contributions recorded as temporarily restricted net assets are released from restrictions and recognized as unrestricted net assets upon receipt of the gift or expiration of the time restriction, and after any donor stipulations are met. Gifts for plant facilities are released from restrictions and recognized as a non-operating item only after resources are expended for the applicable plant facilities.



Contributions receivable of pledged securities are stated at the fair value of the underlying securities. Net changes on shares pledged in prior years due to fair value changes for the underlying securities are reported separately as a non-operating gain or loss on contributions receivable in the Consolidated Statements of Activities.

Operating Results

Operating results (change in unrestricted net assets from operating activity) in the Consolidated Statements of Activities reflect all transactions that change unrestricted net assets, except gifts for plant facilities, activity associated with endowment investments, changes in the value of interest rate swap agreements, and certain other non-recurring items. In accordance with the University's endowment distribution policy, as previously described, only the portion of total investment return distributed under this policy to meet operating needs is included in operating revenue. Operating investment income consists of dividends, interest, and gains and losses on unrestricted, non-endowed investments.

The University's primary programs are instruction, research, patient care, and public service. Academic and student support expenses and auxiliary services are considered integral to the delivery of these programs. Fundraising costs are not material to the University's contributions or total program costs. Approximately 58% of private gifts, grants, and contracts revenue represent transactions where University services are provided to other parties.

Costs related to the operation and maintenance of physical plant, including depreciation of plant assets, are allocated to operating programs and supporting activities based upon facility usage. Interest expense on external debt is allocated to the activities that have benefited most directly from the debt proceeds.

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. The University is, however, subject to federal and state income tax on unrelated business income, and provision for such taxes is included in the accompanying financial statements.

Use of Estimates

The preparation of financial statements requires the use of estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses during the reporting period as

well as the disclosure of contingent assets and liabilities. Actual results ultimately could differ from management's estimates.

Redesignations

When donors amend or clarify intent for applicable gifts and contributions reported in a previous fiscal year, revisions are separately reflected as donor designation changes within the Consolidated Statements of Activities.

Reclassifications

Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

3. Accounts Receivable

Accounts receivable as of June 30 were as follows
(in thousands):

	2006	2005
Patient care	\$ 313,601	\$ 307,109
Students, grants, and other	79,136	74,502
Accrued investment income	6,648	6,959
Accounts receivable	399,385	388,570
Less: Allowance for bad debts	141,818	158,308
Accounts receivable, net	<u>\$ 257,567</u>	<u>\$ 230,262</u>

4. Contributions Receivable

Contributions receivable as of June 30 were as follows
(in thousands):

	2006	2005
Unconditional promises expected to be collected in:		
Less than one year	\$ 22,275	\$ 20,738
One year to five years	69,739	74,879
More than five years	4,869	1,848
Contributions receivable	96,883	97,465
Less: Unamortized discount	8,817	6,794
Allowance for uncollectible promises	7,458	6,290
Contributions receivable, net	<u>\$ 80,608</u>	<u>\$ 84,381</u>

The University's net contributions receivable include amounts due from the Ingram Charitable Fund (ICF) totaling \$21.1 million and \$38.7 million as of June 30, 2006 and 2005, respectively. The assets of the ICF primarily consist of publicly traded Ingram Micro Inc. common stock and privately held Ingram Industries Inc. common stock.

In addition to pledges reported as contributions receivable, the University had received bequest intentions of approximately \$167.2 million as of June 30, 2006. These intentions to give are not recognized as assets due to their conditional nature. If these bequests are received, generally they will be restricted for specific purposes stipulated by the donors, primarily endowments for faculty support, scholarships, or general operating support of a particular department or division of the University.

5. Investments

Investments by security type as of June 30 were as follows
(in thousands):

	2006	2005
Short-term securities	\$ 81,358	\$ 277,301
Bonds	351,083	410,680
Stocks	975,572	1,040,966
Partnership investments	1,636,125	1,263,995
Mortgages	6,834	8,305
Real estate	190,013	156,283
Other	35,351	31,281
Net receivables (payables) for unsettled trades by investment managers	717	(173)
Total fair value	<u>\$3,277,053</u>	<u>\$3,188,638</u>
Total cost	<u>\$2,732,570</u>	<u>\$2,752,160</u>

Investments by net asset category as of June 30 were as follows
(in thousands):

	2006	2005
Unrestricted	\$2,539,668	\$2,490,949
Temporarily restricted	118,974	125,902
Permanently restricted	618,411	571,787
Total fair value	<u>\$3,277,053</u>	<u>\$3,188,638</u>

Through an agreement with its primary investment custodian, the University participates in lending securities to brokers. Among other provisions that limit the University's risk, this agreement specifies that the custodian is responsible for managing strict borrower collateral requirements. Collateral, which is pooled by the custodian, generally is limited to cash, government securities, and irrevocable letters of credit. Depending on the type of securities being lent, minimum collateral ranges from 101% to 105% with required daily marking-to-market.

Both the investment custodian and security borrowers have the right to terminate a specific loan of securities at any time. Other than for an event of default, the investment custodian is prohibited from re-pledging or otherwise encumbering the pledged collateral. The University receives lending fees and continues to earn interest and dividends on the loaned securities.

At June 30, 2006, investment securities with a market value of \$304.5 million were loaned to various approved brokers under this program with collateral having a total market value of \$310.9 million, including cash and cash equivalents of \$271.4 million. The cash and cash equivalents collateral and the obligation to return such collateral are reported as an asset and liability on the Consolidated Statements of Financial Position.



6. Investment Return

As previously noted, the University employs a total return policy that establishes endowment appreciation distributions. Additionally, the Board of Trust authorized the use of funds functioning as endowment to support operating and capital needs of certain transinstitutional initiatives. Endowment distributions in fiscal 2006 and 2005 were based on 4.5% of the previous three years' average calendar year-end market values plus the use of \$10.5 million and \$11.7 million of funds functioning as endowment for operating expenses of transinstitutional initiatives in fiscal 2006 and 2005, respectively.

Further, \$2.3 million and \$6.6 million of unrestricted funds functioning as endowment were utilized for capital needs of transinstitutional initiatives in fiscal 2006 and 2005, respectively. Liquidations for these special capital investments are excluded from the following summary of endowment distributions and other investment income for the fiscal years ended June 30 (*in thousands*):

	2006	2005
Operating:		
Endowment distributions	\$ 109,270	\$ 103,849
Investment income	28,256	28,564
Total operating return	137,526	132,413
Non-operating:		
Unrestricted:		
Endowment appreciation utilized	(112,324)	(106,646)
Investment income	374,907	398,953
Temporarily restricted:		
Endowment distributions	2,816	2,545
Investment income	18,179	16,826
Permanently restricted:		
Endowment distributions	794	252
Investment income	3,018	10,116
Total non-operating return	287,390	322,046
Total investment return	\$ 424,916	\$ 454,459

The components of total investment return for the fiscal years ended June 30 were as follows (*in thousands*):

	2006	2005
Net interest, dividend, and partnership income	\$ 68,051	\$ 58,293
Net realized gains from original cost	247,469	209,374
Net unrealized gains	109,396	186,792
Total investment return	\$ 424,916	\$ 454,459

7. Net Asset Components of Managed Endowment

Vanderbilt's managed endowment represents only those endowment-related net assets that are under the management control of Vanderbilt University. Gift annuities, interest in trusts held by others, and certain contributions pending transfer are not considered components of the managed endowment.

A summary of the University's managed endowment as of June 30 follows (*in thousands*):

	2006	2005
Unrestricted net assets:		
Funds functioning as endowment, at cost	\$1,754,792	\$1,637,322
Net unrealized appreciation on investments	537,895	395,673
Exclude net unrealized losses allocable to other investments	643	4,655
Funds functioning as endowment	2,293,330	2,037,650
Temporarily restricted net assets:		
Funds functioning as endowment, at cost	9,433	—
Permanently restricted net assets:		
True endowment	660,164	603,724
Exclude portion allocable to contributions receivable and other	(47,307)	(43,147)
Managed true endowment	612,857	560,577
Fair value of managed endowment	\$2,915,620	\$2,598,227

8. Property, Plant, and Equipment

Property, plant, and equipment as of June 30 were as follows (in thousands):

	2006	2005
Land	\$ 49,651	\$ 48,385
Buildings and improvements	1,810,770	1,692,707
Moveable equipment	585,484	532,423
Construction in progress	117,178	114,756
Property, plant, and equipment	2,563,083	2,388,271
Less: Accumulated depreciation	1,105,924	1,023,094
Property, plant, and equipment, net	<u>\$1,457,159</u>	<u>\$1,365,177</u>

Purchases for the library collection are not included in the foregoing since they are expensed at the time of purchase. As of June 30, 2006, the estimated replacement cost for library collections, including processing costs to properly identify, catalog, and shelve materials, exceeds \$298.1 million. For both fiscal 2006 and 2005, \$0.7 million of capitalized interest was added to construction in progress. Internally developed software costs of \$3.0 million in 2006 and \$2.6 million in 2005 were capitalized.

9. Long-Term Debt, Commercial Paper, and Capital Leases

Long-term debt consists of bonds and notes payable with scheduled final maturity dates at least one year after the original issuance date. Outstanding long-term debt, commercial paper, and capital lease obligations as of June 30 were as follows (in thousands):

	Years to Maturity	Fiscal 2006 Effective Interest Rate	Outstanding Principal 2006	2005
Fixed-rate long-term debt				
1996 Series A	3	5.7%	\$ 3,265	\$ 4,265
1997 Series A	13	5.4%	23,635	24,870
1998 Series A	10	5.6%	19,700	21,145
1998 Series B	23	5.0%	34,280	35,075
1998 Series C ¹	9	5.0%	17,805	19,370
2001 Series A	10	4.9%	13,655	14,700
2001 Series B ¹	17	5.1%	54,015	56,010
2005 Series B ^{1,2}	38	3.2%	277,750	277,750
HUD	3	3.0%	385	660
Note payable	3	7.3%	8,408	8,802
Other	13	3.0%	227	299
Total fixed-rate long-term debt			453,125	462,946
Variable-rate long-term debt				
2000 Series A	25	3.1%	62,000	63,200
2000 Series B	25	3.1%	62,000	63,200
2002 Series A	27	3.1%	21,370	21,730
2003 Series A ¹	13	3.1%	35,790	38,040
2005 Series A	38	3.0%	113,300	113,300
Total variable-rate long-term debt			294,460	299,470
Par amount of long-term debt			747,585	762,416
Net unamortized premium			12,435	17,175
Total long-term debt			760,020	779,591
Capital leases	3	3.5%	1,767	808
Total long-term debt and capital leases			761,787	780,399
Tax-exempt commercial paper, series A and B	<1	2.8%	144,830	5,500
Total long-term debt, commercial paper, and capital leases			<u>\$ 906,617</u>	<u>\$ 785,899</u>

¹Issued under Master Trust Indenture structure.

²The 2005B bonds are fixed only through put dates in fiscal years 2008 through 2010 when re-marketings could result in differing modes.



The preceding table reflects fixed/variable allocations before the effects of interest rate swap arrangements used by the University to manage its debt portfolio. Such agreements are covered in more detail in a successive footnote.

Tax-exempt commercial paper, as well as all of the aforementioned bonds (with the exception of the HUD bonds), has been issued by the Health and Educational Facilities Board of The Metropolitan Government of Nashville and Davidson County, Tennessee (HEFB). As a conduit issuer, the HEFB loans the debt proceeds to the University. Pursuant to loan agreements, the University's debt service requirements under these loan agreements coincide with required debt service of the actual HEFB bonds.

Included in the foregoing are hospital and clinic (patient care) bonds, with a principal balance outstanding of \$385.4 million as of June 30, 2006, that were issued under a Master Trust Indenture (MTI) structure. The MTI provides the flexibility for multiple parties to participate in debt issuances as part of an obligated group; presently, the University's hospitals and clinics have no other members participating in its obligated group. Bonds issued under the MTI are payable solely from hospital revenues (as defined in the MTI). All MTI bonds presently outstanding are also supplemented by a University guarantee of debt service.

Selected information for long-term debt, commercial paper, and interest rate swap arrangements follows (*in thousands*):

	2006	2005
Interest cost paid	\$ 29,886	\$ 25,954
Interest cost expensed	\$ 26,474	\$ 26,830
Assets held by trustees for subsequent debt service as of June 30	\$ 5,352	\$ 2,024

Principal payments and scheduled sinking fund requirements on the par amount of long-term debt due in subsequent fiscal years ending June 30 are as follows (*in thousands*):

2007	\$ 15,482
2008	16,522
2009	24,481
2010	16,450
2011	17,320
Thereafter	657,330
Total	<u>\$ 747,585</u>

Under certain circumstances, variable-rate bond obligations may be converted to a fixed-rate structure. While these bonds are in a variable rate mode, they are subject to optional and mandatory tender. The University has agreements with remarketing agents to re-market any bonds so tendered. Liquidity for the variable debt portfolio (both commercial paper and variable rate demand bonds) is covered primarily by portfolio self-liquidity, supplemented by a bank revolving credit agreement dedicated solely to debt portfolio liquidity. There were no borrowings outstanding on the revolving credit agreement as of June 30, 2006 or 2005.

Trust indentures for certain bond issues contain covenants and restrictions involving the issuance of additional debt, maintenance of a specified debt service coverage ratio, and the maintenance of liquidity facilities. As of and for the fiscal year ended June 30, 2006, management believes that the University has complied with applicable covenants.

In prior fiscal years, the University defeased certain obligations by irrevocably placing assets with a trustee to pay principal and interest on the obligations as they become due. The outstanding balance of the defeased obligations was \$20.3 million as of June 30, 2006.

In fiscal 2006, the University issued \$139.3 million of commercial paper (CP) under its \$600 million tax-exempt CP program to finance the construction, expansion, and renovation of various University facilities and related equipment, most notably The Commons and the Vanderbilt University Institute of Imaging Science. The University's taxable CP program is authorized for draws up to \$75 million. No draws were made under this CP program during the year.

10. Interest Rate Swap Agreements

To manage the fixed/variable mix for its debt portfolio, including hedging exposure to increasing interest expense from variable-rate debt, the University utilizes interest rate swap agreements.

The fair value of interest rate swap agreements is the estimated amount that the University would pay or receive to terminate these contracts as of the report date. The estimated cumulative gain (loss) for the fair value of these swap agreements was \$23.6 million and (\$45.3) million as of June 30, 2006 and 2005, respectively, and is included in prepaid expenses in 2006, and accounts payable and accrued liabilities in 2005. Changes in the fair value for these contracts, which for fiscal 2006 and 2005 amounted to an unrealized gain of \$68.9 million and an unrealized loss of

\$39.3 million, respectively, were recorded as other non-operating items in the Consolidated Statements of Activities.

Periodic net cash settlement receipts (payments) for all agreements aggregated \$0.5 million and (\$8.4) million for fiscal 2006 and 2005, respectively, and were reflected as adjustments to operating expense in the Consolidated Statements of Activities.

As of June 30, 2006, the University's adjusted debt portfolio, after taking into account the aforementioned derivatives, was approximately 56% fixed and 44% variable.

Outstanding interest rate swap agreements as of June 30 were as follows (*in thousands*):

Origination/ Description	Settlement Provisions	Maturity	Outstanding Notional Amounts	
			2006	2005
January 2002 fixed payer swaps	University receives variable payments based on 70% of London Interbank Offered Rate (LIBOR) and pays fixed amounts at a weighted average rate of 3.990%	Gradual amortization ¹ , corresponding to principal retirements for the University's Series 2000A and 2000B bonds, with final expiration in October 2030	\$124,000	\$126,400
January 2005 fixed payer swaps	University receives variable payments based on 68% of LIBOR and pays fixed amounts at a weighted average rate of 3.433%	Amortization commences in October 2033, corresponding to principal retirements for the University's Series 2005A bonds, with final expiration in October 2044	\$80,000	\$80,000
Other fiscal 2005 fixed payer swaps	University receives variable payments based on 68% of LIBOR and pays fixed amounts at a weighted average rate of 3.460%	Bullet maturities in October 2039	\$315,000	\$315,000
January 2005 fixed receiver swaps	University receives fixed payments averaging 2.997% and pays variable amounts based on the Bond Market Association (BMA) municipal swap index	Amortization commences in April 2008, corresponding to scheduled re-marketings for the University's Series 2005B bonds, with final maturity in April 2010	\$277,750	\$277,750
March 2005 and August 2005 fixed receiver swaps	University receives fixed payments averaging 3.428% and pays variable amounts based on the BMA index	Bullet maturities ² in April 2008 and September 2009	\$200,000	\$100,000
Fiscal 2005 and 2006 basis swaps	University receives payments averaging 82.2% of LIBOR and pays variable amounts based on the BMA index	Bullet maturities in July 2034 and 2035	\$500,000	\$350,000

¹Commencing in October 2012, the counterparty has an option to cancel 50% of the outstanding notional amount without a termination payment, which would result in a remaining fixed payment commitment of 4.175%.

²The counterparty has an option exercisable in April 2008 to extend the transaction for two additional years. If exercised, the fixed payment rate will increase to 3.75%.



11. Net Assets

The University has chosen to provide further classification information about net assets.

Unrestricted net assets are internally designated into the following groups:

Designated for operations represents the cumulative budgeted operating activity of the University and routine equipment replacement reserves.

Designated gifts and grants are composed of departmental gift and grant funds.

Designated for student loans represents University funds set aside to serve as revolving loan funds for students.

Designated for plant facilities represents the net investment in property, plant, and equipment, as well as funds designated for future acquisitions of plant facilities and retirement of debt.

Funds functioning as endowment are amounts set aside by the Board of Trust, intended to generate income in perpetuity to support operating needs. Such amounts include substantially all cumulative realized appreciation on the applicable investments.

Net unrealized appreciation on investments represents cumulative unrealized net gains from original cost on marketable investments. Most of the net unrealized appreciation is attributable to funds functioning as endowment.

Net fair value of interest rate swap agreements represents the mark-to-market valuation for derivative contracts. Because these agreements are intended to serve as long-term hedges within the debt portfolio, segregation apart from other designations is maintained.

Based on the foregoing designations, unrestricted net assets as of June 30 were as follows (*in thousands*):

	2006	2005
Designated for operations	\$ 202,847	\$ 178,048
Designated gifts and grants	131,021	133,434
Designated for student loans	30,735	30,144
Designated for plant facilities	764,280	715,048
Funds functioning as endowment, at cost	1,754,792	1,637,322
Net unrealized appreciation on investments	537,895	395,673
Net fair value of interest rate swap agreements	23,592	(45,283)
Total unrestricted net assets	<u>\$3,445,162</u>	<u>\$3,044,386</u>

Temporarily restricted net assets as of June 30 were composed of the following (*in thousands*):

	2006	2005
Gifts and pledges	\$ 131,210	\$ 152,038
Interest in trusts held by others	7,604	6,824
Life income and gift annuities	16,941	16,181
Total temporarily restricted net assets	<u>\$ 155,755</u>	<u>\$ 175,043</u>

Such temporarily restricted net assets were available for the following purposes as of June 30 (*in thousands*):

	2006	2005
Student scholarships	\$ 1,020	\$ 762
Instruction	3,401	3,837
Capital improvements	10,065	11,801
Subsequent period operations and other	141,269	158,643
Total temporarily restricted net assets	<u>\$ 155,755</u>	<u>\$ 175,043</u>

Permanently restricted net assets as of June 30 were composed of the following (*in thousands*):

	2006	2005
True endowment	\$ 660,164	\$ 603,724
Interest in trusts held by others	35,332	35,958
Life income and gift annuities	29,332	28,320
Total permanently restricted net assets	<u>\$ 724,828</u>	<u>\$ 668,002</u>

12. Natural Classification of Expenses and Allocations

Operating expenses incurred in the fiscal years ended June 30, 2006 and 2005, were as follows (*in thousands*):

	2006	2005
Salaries, wages, and benefits	\$1,397,173	\$1,279,366
Services	117,136	107,144
Supplies and materials	537,928	500,950
Depreciation and amortization	120,980	105,600
Interest	26,474	26,830
Provision for bad debts	130,927	95,464
Utilities, operating leases, and other	97,427	82,895
Total operating expenses	<u>\$2,428,045</u>	<u>\$2,198,249</u>

Based on the functional uses of space on its campus, the University initially allocated depreciation and interest on indebtedness to the various functional expense categories shown below. Subsequent allocations of total institutional and other support costs were made to the University's primary programs. Initial allocations are shown below (*in thousands*):

2006

	Interest	Depreciation
Instruction	\$ 2,723	\$ 15,664
Research	4,652	18,223
Health care services	13,058	50,973
Academic support	894	8,132
Institutional support	730	10,894
Student services	270	1,583
Public service	158	1,156
Room, board, and other auxiliary services	3,989	14,355
Total	<u>\$ 26,474</u>	<u>\$ 120,980</u>

2005

	Interest	Depreciation
Instruction	\$ 2,478	\$ 13,342
Research	4,435	16,357
Health care services	12,656	41,916
Academic support	1,063	7,058
Institutional support	686	8,374
Student services	466	1,689
Public service	127	869
Room, board, and other auxiliary services	4,919	15,995
Total	<u>\$ 26,830</u>	<u>\$ 105,600</u>

13. Retirement Plans

The University's full-time faculty and staff members participate in defined contribution retirement plans administered by third-party investment and insurance firms. For eligible employees with one year of continuous service, these plans require employee and matching employer contributions; such contributions immediately fully vest with the employee.

The University's obligations under these plans are fully funded by periodic transfers to the respective retirement plan administrators with the corresponding expenses recognized in the year incurred. Retirement plan contributions for fiscal 2006 and 2005 were \$39.4 million and \$35.5 million, respectively.

14. Student Financial Aid

The University provides financial aid to students based upon need and merit. This financial assistance is funded by institutional resources, gifts, endowment income, and externally sponsored aid.

In fiscal 2006 and 2005, financial aid for tuition and educational fees of \$128.0 million and \$114.2 million was applied to gross tuition and educational fees of \$316.2 million and \$294.3 million, respectively. In fiscal 2006 and 2005, financial aid for room and board of \$15.6 million and \$14.5 million was applied to gross room and board of \$43.6 million and \$41.5 million, respectively.

Loans to students from University funds are carried at cost, which, based on secondary market information, approximates the fair value of educational loans with similar interest rates and payment terms. Loans receivable from students under governmental loan programs, also carried at cost, can only be assigned to the United States government or its designees. Loan balances are net of allowances for estimated uncollectible accounts of \$3.9 million as of June 30, 2006 and 2005.

Loans to qualified students are funded principally with government advances to the University under the Perkins, Nursing, and Health Professions Student Loan Programs.



15. Related Parties

The University contracts with certain related parties for the purchase of goods, performance of construction activities, and provision of other services. Significant purchases of goods and services from related parties typically are subject to competitive pricing analyses. During fiscal 2006 and 2005, the University had related party transactions approximating \$29.2 million and \$36.6 million, respectively.

16. Conditional Asset Retirement Obligations

In March 2005, the Financial Accounting Standards Board issued Interpretation No. 47 (FIN 47), Accounting for Conditional Asset Retirement Obligations. Under FIN 47, companies must accrue for costs related to legal obligations to perform certain activities in connection with the retirement, disposal, or abandonment of assets. The obligation to perform the asset retirement activity is not conditional, even though the timing or method may be conditional.

Vanderbilt implemented FIN 47 with an effective date of June 30, 2006. Using site-specific surveys, the University identified asbestos abatement or removal as conditional asset retirement obligations, resulting in a liability of \$17.5 million reported as accounts payable and accrued expenses on the Consolidated Statements of Financial Position as of June 30, 2006. Implementation of this pronouncement resulted in \$17.5 million being reflected as the cumulative effect of a change in accounting principle in fiscal 2006.

17. Commitments and Contingencies

(A) *Construction.* At June 30, 2006, approximately \$104.8 million was committed for projects under construction and equipment purchases, to be financed primarily from anticipated debt proceeds.

(B) *Lease Obligations.* The University leases certain equipment and real property. These leases are classified primarily as operating leases and have lease terms ranging up to fifteen years. Total operating lease expense for fiscal 2006 and 2005 was \$47.8 million and \$44.3 million, respectively. Future minimum rentals on non-cancelable operating leases with initial or remaining lease terms in excess of one year as of June 30, 2006, were as follows (*in thousands*):

2007	\$ 27,947
2008	23,105
2009	19,114
2010	10,198
2011	5,959
Thereafter	16,410
Total future minimum rentals	<u>\$ 102,733</u>

In conjunction with its normal business practices related to the leasing of equipment, in February 2005 and March 2004, the University established financing mechanisms via \$16.4 million and \$40.0 million, respectively, of tax-exempt bonds issued by the Health and Educational Facilities Board of the Metropolitan Government of Nashville and Davidson County, Tennessee. Payments made by the University under these financing mechanisms are reported as operating lease expense and are included in the future minimum rentals above.

(C) *Litigation.* The University is a defendant in several legal actions. Management believes that the outcome of these actions will not have a significant effect on the University's financial position.

(D) *Medical Malpractice Liability Insurance.* The University is self-insured for the first level of medical malpractice claims. The current self-insured limits are \$5.5 million per occurrence, not to exceed an annual aggregate of \$41.0 million. For this self-insured retention, a trust fund has been established. The funding of the trust is based upon studies performed by an actuarial firm. Excess malpractice and professional liability coverage has been obtained from commercial insurance carriers on a claims-made basis for claims above the retained self-insurance risk levels.



E) *Employee Health and Workers Compensation Insurance.* In addition to the initial tier of self-insured exposure for medical malpractice liability as previously noted, the University also is self-insured for employee health insurance and workers compensation coverage. Actuarial liabilities are recorded based upon studies performed by actuarial firms.

(F) *Federal and State Contracts and Other Requirements.* Expenditures and F&A 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 that may be disallowed by the granting agencies cannot be determined at this time, although management expects they will not have a significant effect on the University's financial position.

(G) *Health Care Services Revenue.* Revenue from health care services includes amounts paid under reimbursement agreements with certain third-party payers and is subject to examination and retroactive adjustments. Any differences between estimated year-end settlements and actual final settlements are reported in the year final settlements are known. Substantially all settlements have been made through the year ended June 30, 2003.

In August 1996, Congress approved the Health Insurance Portability and Accountability Act of 1996 (Act). Under the Act, the federal government was given substantial resources and authority for the completion of fraud and abuse investigations, and the Act has established substantial fines and penalties for offenders. Management continues to refine policies, procedures, and organizational structures to enforce and monitor compliance with this Act, as well as other government statutes and regulations.

The medical center's compliance with laws and regulations is subject to future government review and interpretations, as well as regulatory actions unknown or unasserted at this time. Management believes that liability, if any, from such reviews will not have a significant effect on the University's financial position.

(H) *Partnership Investment Commitments.* There were \$763.1 million of commitments to venture capital, real estate, and distressed security investments as of June 30, 2006. These funds may be drawn down over the next several years upon request by the general partners. As of June 30, 2006, \$51.2 million of unallocated cash and cash equivalents in the managed endowment are held to meet these obligations. Management expects to

finance these commitments with available cash and expected proceeds from the sale of securities.

(I) *McKendree Village, Inc. Debt Guaranty.* In July 1998, Vanderbilt University and McKendree Village, Inc., a not-for-profit retirement community, entered into a joint venture agreement. In September 1998, the University guaranteed payment of \$19.8 million of debt issued by McKendree Village. As of June 30, 2006, the balance of the guaranteed debt was \$18.1 million.