



University of Hawai'i
State of Hawai'i
Consolidated Financial Statements
June 30, 2005 and 2004

University of Hawai'i
State of Hawai'i
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June 30, 2005 and 2004

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UNIVERSITY OF HAWAI'I

David McClain
Interim President

February 22, 2006

Chairperson Kitty Lagareta
Members of the Board of Regents
2444 Dole Street
Honolulu, Hawai'i 96822

Dear Chairperson Lagareta:

I am pleased to submit the Financial Report of the University of Hawai'i for the year ended June 30, 2005.

This report has been prepared by the staff of the Vice President for Budget and Finance and Chief Financial Officer in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board Statement No. 35, "*Basic Financial Statements and Management's Discussion and Analysis for Public Colleges and Universities*," and Statement No. 34, "*Basic Financial Statements and Management Discussion and Analysis for State and Local Governments*".

Our financial report as of June 30, 2005 includes a "Statement of Net Assets", "Statement of Revenues, Expenses, and Changes in Net Assets", "Statement of Cash Flows", "Notes to the Financial Statements", and "Management's Discussion and Analysis (MD&A)". The financial data of the University of Hawai'i System includes the University of Hawai'i, the Research Corporation of the University of Hawai'i and the University of Hawai'i Foundation.

The financial statements herein have been audited by PricewaterhouseCoopers LLP, Independent Accountants, whose Report of Independent Auditors is on page 2.

Respectfully submitted,

A handwritten signature in cursive script that reads "David McClain".

David McClain
Interim President

Attachment

Report of Independent Auditors

To the Board of Regents of the
University of Hawaii

In our opinion, based on our audits and the reports of other auditors, the accompanying consolidated statements of net assets and the related consolidated statements of revenues, expenses and changes in net assets, and cash flows present fairly, in all material respects, the financial position of the University of Hawaii (the "University") at June 30, 2005 and 2004, and the changes in financial position and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These consolidated financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of the University of Hawaii Foundation (the "Foundation") and the Research Corporation of the University of Hawaii (the "Research Corporation"), whose statements collectively reflect total assets of 11.8 percent and 11.5 percent of the related consolidated total as of June 30, 2005 and 2004 and operating revenues of 0.2 percent and 0.3 percent of the related consolidated operating revenues for the years then ended, of the University's consolidated assets and operating revenues, respectively. Those statements were audited by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for the Foundation and Research Corporation, are based solely on the report of the other auditors. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

The Management's Discussion and Analysis ("MD&A") for the years ended June 30, 2005 and 2004 on pages 3 through 27 are not a required part of the consolidated financial statements but are supplementary information required by the Government Accounting Standards Board ("GASB"). 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.

In accordance with Government Auditing Standards, we have also issued our report dated February 7, 2006 on our consideration of the University's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters for the year ended June 30, 2005. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

PricewaterhouseCoopers LLP

Honolulu, Hawaii
February 7, 2006

**University of Hawai'i
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Management's Discussion and Analysis (Unaudited)
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Introduction

The following discussion and analysis provides an overview of the consolidated financial position and activities of the University of Hawai'i (the "University") for the years ended June 30, 2005 and 2004, with selected information for the year ended June 30, 2003. This discussion has been prepared by management and should be read in conjunction with the financial statements and the notes thereto, which follow this section.

Founded in 1907 under the auspices of the Morrill Act, the University is a land-grant, sea-grant, and space-grant institution. The University system distinguishes itself through its Hawaiian, Asian, and Pacific orientation and its position as one of the world's foremost multicultural centers for global and indigenous studies. Students are members of a population in which no one ethnic group constitutes a majority, and the educational experience is enriched by the diversity of cultures represented.

The University is Hawai'i's sole public higher education system and is governed by a Board of Regents composed of twelve members appointed by the Governor of the State of Hawai'i. The University system is represented by ten campuses with approximately 50,000 students and 9,000 faculty and staff. The University provides a broad range of 276 degree programs from baccalaureate to post-doctoral level, through a framework of sixteen colleges and nine professional schools. Through its seven community colleges on Oahu, Hawaii, Maui, and Kauai, the University offers a wide range of 152 certificate and 119 associate degree programs. In addition, the University operates three university centers, multiple learning centers, and extension, research, and service programs at more than 70 sites in the State of Hawai'i. The University is also engaged in instructional, research and service activities at hundreds of Hawai'i schools, hospitals and community sites, and carries out these activities across the Pacific Islands and in foreign countries.

Using the Financial Statements

The University's consolidated financial statements are prepared in accordance with Government Accounting Standards Board ("GASB") principles, which establish standards for external financial reporting for public colleges and universities. The University's consolidated financial statements are comprised of the following three components:

- **Statement of Net Assets** – The Consolidated Statements of Net Assets separates current and non-current assets and liabilities, with resources classified for accounting and reporting purposes into four net asset categories.
- **Statement of Revenues, Expenses and Changes in Net Assets** – The Consolidated Statements of Revenues, Expenses and Changes in Net Assets distinguishes operating from non-operating revenues and expenses. Tuition and fees revenue and student housing fees revenue are reported net of scholarships and fellowships, including tuition and fee waivers applied to student accounts. It is anticipated that the University will consistently report an operating loss since certain significant revenue sources relied upon for core operational needs, including state appropriations, private gifts and investment income, are considered non-operating revenues.

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- **Statement of Cash Flows** – The Consolidated Statements of Cash Flows distinguishes between cash inflows and outflows from operating activities, non-capital financing activities, capital and related financing activities, and investing activities.

Related Entities

The University maintains close relationships with two other entities, considered to be component units, and whose financial information is blended into the University's accompanying financial statements. The University of Hawai'i Foundation (the "Foundation") is a not-for-profit organization established to solicit and manage funds for the benefit of the University. The Research Corporation of the University of Hawai'i (the "Research Corporation") provides administrative support services for research and training programs of the University. Both of the University's component units prepare stand-alone financial statements with footnotes, which are audited by independent auditors. The following tables summarize the individual components of the University's consolidated financial position and results of operations for the years ended June 30, 2005, 2004 and 2003 (in thousands):

	2005				
	University	Research Corporation	Foundation	Consolidation Adjustments	Total
Current assets	\$ 356,071	\$ 29,240	\$ 4,195	\$ (17,518)	\$ 371,988
Noncurrent assets	1,081,733	5,288	177,090	(6,366)	1,257,745
Total assets	1,437,804	34,528	181,285	(23,884)	1,629,733
Current liabilities	161,688	23,523	1,405	(18,170)	168,446
Noncurrent liabilities	225,373	1,120	5,981	(239)	232,235
Total liabilities	387,061	24,643	7,386	(18,409)	400,681
Net assets	\$ 1,050,743	\$ 9,885	\$ 173,899	\$ (5,475)	\$ 1,229,052
	2004				
	University	Research Corporation	Foundation	Consolidation Adjustments	Total
Current assets	\$ 346,189	\$ 28,868	\$ 2,611	\$ (15,874)	\$ 361,794
Noncurrent assets	973,876	3,371	157,261	(5,225)	1,129,283
Total assets	1,320,065	32,239	159,872	(21,099)	1,491,077
Current liabilities	143,417	23,164	1,016	(17,154)	150,443
Noncurrent liabilities	228,971	725	5,887	-	235,583
Total liabilities	372,388	23,889	6,903	(17,154)	386,026
Net assets	\$ 947,677	\$ 8,350	\$ 152,969	\$ (3,945)	\$ 1,105,051

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	2003				
	University	Research Corporation	Foundation	Consolidation Adjustments	Total
Current assets	\$ 356,567	\$ 31,466	\$ 1,617	\$ (22,452)	\$ 367,198
Noncurrent assets	940,516	2,790	131,396	(3,132)	1,071,570
Total assets	1,297,083	34,256	133,013	(25,584)	1,438,768
Current liabilities	135,661	27,051	1,299	(21,694)	142,317
Noncurrent liabilities	234,519	602	4,689	-	239,810
Total liabilities	370,180	27,653	5,988	(21,694)	382,127
Net assets	\$ 926,903	\$ 6,603	\$ 127,025	\$ (3,890)	\$ 1,056,641

	2005				
	University	Research Corporation	Foundation	Consolidation Adjustments	Total
Operating revenue	\$ 550,495	\$ 5,833	\$ 6,528	\$ (11,207)	\$ 551,649
Operating expense	1,012,363	4,651	25,112	(16,234)	1,025,892
Operating income (loss)	(461,868)	1,182	(18,584)	5,027	(474,243)
Nonoperating activity	564,934	353	39,514	(6,557)	598,244
Increase (decrease) in net assets	103,066	1,535	20,930	(1,530)	124,001
Net assets					
Beginning of year	947,677	8,350	152,969	(3,945)	1,105,051
End of year	\$ 1,050,743	\$ 9,885	\$ 173,899	\$ (5,475)	\$ 1,229,052

	2004				
	University	Research Corporation	Foundation	Consolidation Adjustments	Total
Operating revenue	\$ 517,588	\$ 5,277	\$ 8,101	\$ (11,648)	\$ 519,318
Operating expense	942,350	3,753	22,420	(14,140)	954,383
Operating income (loss)	(424,762)	1,524	(14,319)	2,492	(435,065)
Nonoperating activity	444,888	223	40,263	(1,899)	483,475
Increase in net assets	20,126	1,747	25,944	593	48,410
Net assets					
Beginning of year	927,551	6,603	127,025	(4,538)	1,056,641
End of year	\$ 947,677	\$ 8,350	\$ 152,969	\$ (3,945)	\$ 1,105,051

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	2003				Total
	University	Research Corporation	Foundation	Consolidation Adjustments	
Operating revenue	\$ 474,495	\$ 4,615	\$ 3,667	\$ (7,396)	\$ 475,381
Operating expense	907,032	4,209	20,853	(10,169)	921,925
Operating income (loss)	(432,537)	406	(17,186)	2,773	(446,544)
Nonoperating activity	527,955	164	17,226	(1,729)	543,616
Increase in net assets	95,418	570	40	1,044	97,072
Net assets					
Beginning of year	832,133	6,033	126,985	(5,582)	959,569
End of year	\$ 927,551	\$ 6,603	\$ 127,025	\$ (4,538)	\$ 1,056,641

Financial Position

The statement of net assets presents the financial position of the University at the end of the fiscal year and displays all assets and liabilities of the University. Assets and liabilities are generally measured using current values. Two notable exceptions are receivables and capital assets, which are stated at historical cost less an allowance for doubtful accounts and depreciation, respectively. The difference between assets and liabilities is net assets, representing a measure of the current financial condition of the University. The University's financial position remained strong at June 30, 2005, with assets of \$1.6 billion, liabilities of \$400.7 million, and net assets of \$1.2 billion, a \$124.0 million increase from fiscal year 2005. The University's assets, liabilities and net assets at June 30, 2005, 2004 and 2003 are summarized as follows (in thousands):

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	2005	Percentage of Total Assets	2004	Percentage of Total Assets	FY 05 vs 04 Change	2003	Percentage of Total Assets	FY 04 vs 03 Change
Current assets								
Cash and operating investments	\$ 247,735	15%	\$ 263,121	18%	\$ (15,386)	\$ 259,494	18%	\$ 3,627
Receivables, net	106,004	7%	82,270	6%	23,734	92,234	7%	(9,964)
Other current assets	18,249	1%	16,403	1%	1,846	15,470	1%	933
	<u>371,988</u>	23%	<u>361,794</u>	25%	<u>10,194</u>	<u>367,198</u>	26%	<u>(5,404)</u>
Noncurrent assets								
Endowment and other investments	240,661	15%	288,352	19%	(47,691)	293,283	20%	(4,931)
Capital assets, net	969,626	59%	799,336	53%	170,290	730,130	51%	69,206
Other noncurrent assets	47,458	3%	41,595	3%	5,863	48,157	3%	(6,562)
Total assets	<u>1,629,733</u>	100%	<u>1,491,077</u>	100%	<u>138,656</u>	<u>1,438,768</u>	100%	<u>52,309</u>
Current liabilities								
	168,446	10%	150,443	10%	18,003	142,317	10%	8,126
Noncurrent liabilities								
Long-term debt	175,464	11%	179,323	12%	(3,859)	184,028	13%	(4,705)
Other noncurrent liabilities	56,771	4%	56,260	4%	511	55,782	4%	478
Total liabilities	<u>400,681</u>	25%	<u>386,026</u>	26%	<u>14,655</u>	<u>382,127</u>	27%	<u>3,899</u>
Net assets								
Invested in capital assets,								
net of related debt	803,238	49%	692,610	46%	110,628	667,383	46%	25,227
Restricted								
Nonexpendable	104,948	6%	97,384	7%	7,564	88,921	6%	8,463
Expendable	123,273	8%	110,713	7%	12,560	89,721	6%	20,992
Unrestricted	197,593	12%	204,344	14%	(6,751)	210,616	15%	(6,272)
Total net assets	<u>\$ 1,229,052</u>	75%	<u>\$ 1,105,051</u>	74%	<u>\$ 124,001</u>	<u>\$ 1,056,641</u>	73%	<u>\$ 48,410</u>

A review of the University's statement of net assets at June 30, 2005, 2004 and 2003 shows that the University continues to build upon its strong financial foundation. Its financial health reflects the prudent utilization of its financial resources, including careful cost controls, management of its endowment, conservative utilization of debt and adherence to its long range capital plan for the maintenance and replacement of physical plant.

Current Assets and Liabilities

Current assets consist primarily of cash, operating investments and accounts receivable. Total current assets increased by \$10.2 million or 2.8 percent at June 30, 2005, primarily due to a \$23.7 million increase in receivables offset by a decrease in cash and cash equivalents and operating investments of \$15.4 million. Receivables, net of allowances for doubtful accounts, increased by \$23.7 million or 28.8 percent to \$106.0 million at June 30, 2005, primarily due to several large Letter of Credit (LOC) and advance account billings that occurred late in the fiscal year. The sponsors involved with some of these large accounts receivable billings are the National Science Foundation, U.S. Department of Agriculture and the U.S. Department of Health. Total current assets decreased by \$5.4 million or 1.5 percent at June 30, 2004 as compared to June 30, 2003, due primarily to a decrease in receivables and cash and cash equivalents, offset by an increase in operating investments. Receivables, net of allowances for doubtful accounts, decreased by \$10.0 million or 10.8 percent to \$82.3 million at June 20, 2004, primarily due to an earlier cash draw-down procedure instituted at the Office of Research Services ("ORS"). The cash draw was done in weekly intervals in fiscal year 2004 as opposed to every two weeks in fiscal year 2003. More timely draw-downs resulted in lower receivable totals.

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Current liabilities consist primarily of accounts payable, accrued compensation, advances from sponsors, and deferred revenue. Current liabilities also include accrued interest payable, amounts due to the State of Hawai'i, and the current portion of long-term debt. Total current liabilities increased by \$18 million or 12.0 percent at June 30, 2005 as compared to the prior year, due primarily to increases in accounts payable and accrued compensation and benefits, offset by a decrease in investment trade settlements payable and accrued interest. Total current liabilities increased by \$8.1 million or 5.7 percent at June 30, 2004 as compared to June 30, 2003, due primarily to increases in accounts payable and accrued compensation and benefits, offset by a decrease in accrued interest and advance from sponsors.

Endowment and Other Investments

The University's endowment and other investments, including endowments held with the Foundation, decreased by \$47.7 million to \$240.7 million at June 30, 2005. Endowments and other investments held with the Foundation amounted to \$153.4 million at June 30, 2005. The decrease was primarily attributable to investment sales needed to fund construction expenditures for the John A. Burns School of Medicine building offset by the receipt of additional endowment gifts. As of June 30, 2004, the University's endowment and other investments, including endowments held with the Foundation, decreased by \$4.9 million to \$288.4 million. Endowments and other investments held with the Foundation amounted to \$137.2 million at June 30, 2004. Similar to fiscal year 2005, fiscal year 2004's decrease was due to the sale of investments to fund expenditures related to the construction of the John A. Burns School of Medicine building offset by the receipt of additional endowment gifts.

The University's endowment funds consist of both permanent endowments and funds functioning as endowment (quasi-endowment funds). Permanent endowment funds are funds received from donors or other outside agencies with the stipulation that the principal be maintained inviolate and be invested in perpetuity for the purpose of producing present and future income which may either be expended for the purposes specified by the donor or added to principal. Quasi-endowment funds are funds which the Board of Regents, rather than a donor or other outside agency, has allocated for long-term investment purposes. The Board of Regents, in accordance with its policies, is not required to maintain the quasi-endowment principal in perpetuity. Quasi-endowment funds are further categorized as restricted and unrestricted. Restricted quasi-endowment funds represent donor-restricted gifts, without the requirement to maintain the principal in perpetuity. Unrestricted quasi-endowment funds represent unrestricted funds designated by the Board of Regents for long-term investment purposes.

Programs supported by the University's permanent and quasi-endowment funds include scholarships, fellowships, professorships, research efforts and other important programs and activities. The University uses its endowment to support operations by generating a predictable stream of annual support for current needs, while preserving the purchasing power of the endowment funds for future periods.

Effective for fiscal year 2004, the University adopted a spending rate policy with the intent of limiting the immediate impact that significant changes in the fair value of the endowment portfolio have on annual distributions. The spending rate policy provides for an annual distribution, ranging between three and six percent of the five-year moving average of the endowment portfolio's fair value. In accordance with the Board of Regents' distribution policy in fiscal year 2005, the University instituted a 4 percent distribution on restricted endowment and a 4 percent distribution on unrestricted endowment. The total restricted and unrestricted distribution for the University in 2005 totaled \$2 million. For fiscal year 2004, the University instituted a three percent distribution on restricted endowment and four percent distribution on

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unrestricted endowment. The total restricted and unrestricted distribution for the University in 2004 amounted to \$1.8 million.

Capital and Debt Activities

The University's capital assets are separated into seven categories: land, buildings, infrastructure, land improvements, equipment, library books, and construction in progress. At June 30, 2005 and 2004, total capital assets, net of accumulated depreciation amounted to \$969.6 million and \$799.3 million, respectively, which represented 59.5 percent and 53.6 percent of the University's total assets at June 30, 2005 and 2004, respectively. Capital asset additions totaled \$235.2 million in fiscal year 2005, while depreciable capital asset disposals, net of accumulated depreciation amounted to \$10.1 million. Approximately \$158.9 million of fiscal year 2005 capital asset additions were related to the renovation, improvement and construction of buildings. In addition, during fiscal year 2005, approximately \$56.1 million and \$6.4 million of these capital asset additions were related to building and infrastructure projects administered by the State of Hawai'i Department of Accounting and General Services ("DAGS") – Public Works Division and transferred to the University, respectively. Purchases of equipment, including information technology, amounted to approximately \$19 million during fiscal year 2005 and purchases of library books amounted to approximately \$8 million.

At June 30, 2004 and 2003, total capital assets, net of accumulated depreciation amounted to \$799.3 million and \$730.1 million, respectively, which represented 53.6 percent and 50.7 percent of the University's total assets at June 30, 2004 and 2003, respectively. Capital asset additions totaled \$115.1 million in fiscal year 2004, while capital asset disposals, net of accumulated depreciation amounted to \$2.1 million. Approximately \$68.6 million of fiscal year 2004 capital asset additions were related to the renovation, improvement and construction of buildings, of which \$60.6 million was related to construction in progress and \$275,000 was related to capital improvement projects administered by DAGS and transferred to the University. Purchases of equipment, including information technology, amounted to approximately \$16 million during fiscal year 2004 and purchases of library books amounted to approximately \$5 million.

One of the critical factors in continuing the quality of the University's academic and research programs and student life enrichment is the development and renewal of capital assets. The University continues to modernize its older teaching and research facilities, and develop and construct new facilities.

Significant capital projects completed during fiscal year 2005 and 2004 or in progress as of June 30, 2005 and June 30, 2004 included:

- **John A. Burns School of Medicine** – In April 2005 the University completed the construction and furnishing of the Medical Education Building at the John A. Burns School of Medicine in Kaka'ako and continued Phase I of the construction work on the remaining new structures. The 114,546 square foot Medical Education Building that houses teaching facilities, faculty and administrative staff offices and a café was occupied soon after the facility was completed and furnished. The Medical Research Building, when completed, will provide 184,142 square feet of laboratory, office, and support space for research staff. The child care and fitness centers, loading docks, and central mechanical plant, totaling 18,537 square feet, will be adjacent to the Medical Research Building. Parking for the first phase will include 221 stalls of surface parking on site and approximately 400 stalls on the adjacent 5.5 acre site that will be leased from Hawai'i Community Development

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Authority. As of June 30, 2005, the University incurred approximately \$136,348,000 in construction costs and the project was estimated to be 90.1 percent completed. At June 30, 2004, the University incurred approximately \$69,808,000 in construction costs and the project was estimated to be 46.5 percent complete. Phase one of the project is anticipated to be completed in early fiscal year 2006.

- **Mauna Kea Astronomy Education Center (MKAEC)** - The design, construction, and furnishing of the 44,000 square foot Mauna Kea Astronomy Education Center (MKAEC) that began in fiscal year 2002, was serviced-ordered to the Research Corporation of the University of Hawai'i (RCUH). The MKAEC, officially renamed 'Imiloa, the Astronomy Center of Hawaii, was envisioned as a state of the art educational facility from which to impart today's cutting-edge scientific knowledge of the Universe as well as convey the importance of the early astronomical skills of the ancient Hawaiians to the general public. The importance and uniqueness of Mauna Kea as an astronomical location will also be showcased. Funded primarily through grants from the National Aeronautics and Space Administration, design and construction costs were approximately \$14.5 million as of June 30, 2005 with approximately 75 percent of the project completed.
- **Upgrade of Athletic and Sports Teaching Facilities** - The steady transformation of the University's lower campus at Mānoa has continued with the complete renovation and upgrade of the outdoor tennis facility. Designed and constructed at a cost of \$3.3 million, the new facility, which provides a total of twelve courts with vastly improved lighting and fencing, was completed in February 2005. Additionally, phased improvements to the makai training room for student-athletes within the Physical Education and Athletic Complex were in-progress as of June 30, 2005 with incurred costs of approximately \$1,020,000.
- **DAGS Administered Capital Projects** - A significant portion of the University's major construction projects are administered and financed by DAGS. In fiscal year 2005, DAGS transferred to the University a total of \$62.6 million in current and prior year construction and renovation projects involving State of Hawai'i funding participation in numerous building and infrastructure assets. These projects included: Hawaii Institute of Geophysics Lab Wing and Lecture Hall Addition - \$1,063,599; Bilger Hall Interior Improvements - \$438,960; UHM Electrical Distribution System Phase IV Improvements - \$3,279,773; Pacific Ocean Science & Technology Building (Initial, Phase IA, Phase IB, and Phase II) - \$41,661,188; Agricultural Science Facility - \$13,036,767; and UH Hilo Utility Grid Phase II - \$3,145,994.

At June 30, 2005 and 2004, amounts due to the State of Hawai'i for general obligation bonds payable amounted to \$9.1 million and \$12 million, respectively. For fiscal year 2005, debt service paid by the University amounted to \$3.4 million consisting of \$2.9 million for principal and \$529,871 for interest. In fiscal year 2004, debt service paid by the University amounted to \$2.0 million consisting of \$1.4 million for principal and \$596,987 for interest. General obligation bonds have also been issued by the State of Hawai'i on behalf of the University and are carried as a liability of the State of Hawai'i. Debt service on these general obligation bonds amounted to \$45.4 and \$45.7 million in fiscal years 2005 and 2004, respectively, and were paid for by the State of Hawai'i on behalf of the University using state appropriations.

In June 2005, the State of Hawai'i issued Series DG & DH general obligation ("G.O.") refunding bonds. Proceeds from the Series DG & DH G.O. refunding bonds were used to partially refund a range of G.O.

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bonds, including the Series CG G.O. bonds for various State Departments including the University of Hawai'i.

At June 30, 2005 and 2004, revenue bonds payable amounted to \$163.9 million and \$167.4 million, respectively. Debt service in fiscal year 2005 amounted to \$11.8 million consisting of \$3.5 million for principal and \$8.3 million for interest. Debt service for fiscal year 2004 amounted to \$13.4 million consisting of \$890,000 for principal and \$12.5 million for interest. Principal reductions during fiscal year 2005 and 2004 were in accordance with scheduled debt service payments.

In June 2002, the University issued \$150 million in Series 2002A revenue bonds to finance the construction of the new John A. Burns School of Medicine campus. While all unrestricted revenues of the University, excluding those revenues pledged under other revenue bond offerings, are pledged as collateral, the University anticipates that State of Hawai'i Tobacco Settlement funds will be the primary source of support for debt service payments on these revenue bonds. In June 2005 and May 2004, the University received \$10.0 million in State of Hawai'i Tobacco Settlement funds to cover the debt service due in fiscal year 2005. In June 2003, the University received \$11.6 million in State of Hawai'i Tobacco Settlement funds to cover the first interest payments under these bonds which were due in fiscal year 2004.

On August 13, 2004, Moody's Investors Service ("Moody's") downgraded the underlying debt rating on the University's \$150 million of Series 2002A bonds from the Aa3 rating held on June 30, 2004 and 2003 to A1, while the Standard & Poor's and Fitch Rating Services ("S&P and Fitch") continued to reaffirm their A+ rating for the years ended June 30, 2005, 2004 and 2003. The downgrade was a result of Moody's growing concern regarding tobacco settlement bonds, resulting in the downgrade of all tobacco settlement collateralizations, and lower tobacco revenue projections. The A1 rating by Moody's and A+ rating by S&P and Fitch were based on the University's important state-wide role in education, research, and economic development; growing enrollment levels; adequate financial reserves and operating performance; and a close relationship with the Aa3-rated State of Hawaii.

In addition to the general obligation and revenue bond liabilities discussed above, the University entered into a capital lease to finance the construction of the Kau'ioakahaloa Nui faculty housing project in November 1995. At June 30, 2005 and 2004, capital lease obligations amounted to \$15.1 million and \$15.4 million, respectively. Debt service in fiscal year 2005 amounted to \$1.2 million consisting of \$380,000 for principal and \$858,635 for interest. Debt service in fiscal year 2004 amounted to \$1.2 million consisting of \$360,000 for principal and \$876,030 for interest.

Net Assets

Net assets represent the residual interest in the University's assets after liabilities are deducted. At June 30, 2005 and 2004, total net assets amounted to \$1.2 billion and \$1.1 billion, respectively. Net assets are reported in four major categories: invested in capital assets, net of related debt; restricted nonexpendable; restricted expendable; and unrestricted.

Net assets invested in capital assets, net of accumulated depreciation and the related outstanding debt used to finance the acquisition, construction or improvement of those assets, amounted to \$803.2 million and \$692.6 million at June 30, 2005 and 2004, respectively, an increase of \$110.6 million in fiscal year 2005 and \$25.2 million in fiscal year 2004. The fiscal year 2005 increase represents \$235 million of capital

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asset additions, less \$77 million of debt financed medical school additions and \$54 million of depreciation expense. The fiscal year 2004 increase represents \$115 million of capital asset additions, less \$53 million of debt financed medical school additions and \$44 million of depreciation expense.

Restricted nonexpendable net assets representing the University's and the Foundation's permanent endowment funds, which are required to be maintained in perpetuity, amounted to \$104.9 million and \$97.4 million at June 30, 2005 and 2004, respectively. The increase of \$7.6 million was primarily attributable to new permanent endowment gifts received during fiscal year 2005.

Restricted expendable net assets, subject to externally imposed restrictions governing their use, consisted of net assets that were restricted for the following purposes at June 30, 2005, 2004 and 2003 (in thousands):

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Plant facilities	\$ 2,678	\$ 3,270	\$ 3,490
Donor restricted activities	87,195	75,759	55,548
Loan activities	27,408	26,817	27,074
External sponsor activities	5,992	4,867	3,609
	<u>\$ 123,273</u>	<u>\$ 110,713</u>	<u>\$ 89,721</u>

The overall increase in restricted expendable net assets was attributable to the large influx of donor restricted funds at Foundation.

Net assets that are not subject to externally imposed restrictions governing their use must be classified as unrestricted for financial reporting purposes. Although unrestricted net assets are not subject to externally imposed restrictions, all of the University's unrestricted net assets have been internally designated for various academic and research programs and initiatives, contractual commitments, and capital projects. In addition, unrestricted net assets of \$36.3 million, \$36.0 million and \$32.4 million were designated for endowment activities at June 30, 2005, 2004 and 2003 respectively. Unrestricted net assets were comprised of the following at June 30, 2005, 2004 and 2003 (in thousands):

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Designated			
Capital projects	\$ 118,163	\$ 124,166	\$ 137,896
Research and training	40,207	40,152	35,404
Quasi-endowment	36,283	35,964	32,401
Bond system	19,427	19,045	16,905
Contractual commitments	16,442	12,133	15,742
Other	8,095	7,475	5,991
	<u>238,617</u>	<u>238,935</u>	<u>244,339</u>
Undesignated (unfunded obligations for vacation, worker's compensation liabilities, payroll, etc).	<u>(41,024)</u>	<u>(34,591)</u>	<u>(33,723)</u>
	<u>\$ 197,593</u>	<u>\$ 204,344</u>	<u>\$ 210,616</u>

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Results of Operations

The statement of revenues, expenses and changes in net assets is a presentation of the University's results of operations for the year. It indicates whether the financial condition of the University improved or deteriorated. For financial reporting purposes, certain significant revenues, including state appropriations, private gifts, and investment income, which are relied upon and budgeted for to support the University's core operations, are required to be reported as nonoperating revenues.