1. Organization and Summary of Significant Accounting Policies

Financial Reporting Entity
The accompanying financial statements of the University of Hawai'i (the "University") include the activities of the University of Hawai'i at Mānoa, University of Hawai'i at Hilo, University of Hawai'i at West O'ahu, University of Hawai'i Community Colleges and the financial reporting entities of the University. The University has defined its reporting entities in accordance with Governmental Accounting Standards Board ("GASB") Statement No. 14, *The Financial Reporting Entity*, as amended by GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*. The basic criterion for including a potential component unit within the reporting entity is financial accountability. Other criteria include fiscal dependency and the nature and significance of the relationship are such that exclusion would cause the financial statements of the University to be misleading. Accordingly, the financial information of the Research Corporation of the University of Hawai'i (the "Research Corporation") and the University of Hawai'i Foundation (the "Foundation"), have been blended with the University's accounts in the accompanying financial statements.

Complete financial statements of the Research Corporation can be obtained at the Research Corporation of the University of Hawai'i, 2800 Woodlawn Drive, Honolulu, HI 96822. The Foundation's federal Form 990 is available for inspection as required by Internal Revenue Code (IRC) Section 6104 at the University of Hawai'i Foundation, 2444 Dole Street, Bachman Hall, Room 101, Honolulu, HI 96822.

Similarly, the University is fiscally dependent upon, and a component unit of the State of Hawai'i (the "State") and therefore, the State is financially accountable for the University as defined by GASB Statement No. 14. Accordingly, the University's financial information is presented within the State's comprehensive annual financial report.

The University is classified as a state instrumentality under Internal Revenue Code Section 115, and is therefore exempt from federal income taxes. Certain activities of the University may be subject to taxation as unrelated business income under IRC Sections 511 and 514.

Basis of Presentation
The University follows the reporting model prescribed for special-purpose governments engaged only in business-type activities, as defined in GASB Statement No. 35, *Basic Financial Statements and Management's Discussion and Analysis for Public Colleges and Universities,* as amended by GASB Statements No. 37 and No. 38. The financial statements of the University are presented using the economic resources measurement focus and the accrual basis of accounting in accordance with standards for governmental colleges and universities. Accordingly, the University has adopted all GASB pronouncements and all Financial Accounting Standards Board ("FASB") pronouncements issued on or before November 30, 1989, which do not contradict or conflict with existing GASB pronouncements.

The Foundation's accounting policies conform to generally accepted accounting principles ("GAAP") applicable to not-for-profit organizations as promulgated by the FASB. The Foundation's financial information has been converted to conform to the University's presentation.

The Research Corporation's accounting policies conform to GAAP applicable to enterprise activities of governmental units as promulgated by the GASB. The Research Corporation's financial information was converted to conform to the University's presentation.

Cash and Cash Equivalents
The University considers all highly liquid debt instruments, including short-term cash investments, purchased with an original maturity of three months or less to be cash equivalents. The carrying amounts reported in the Statements of Net Assets for cash equivalents approximate fair value due to the short maturity of these instruments.

Restricted Cash and Cash Equivalents
The University considers cash and cash equivalents obtained from the issuance of the University Health and Wellness Center revenue bonds which have not been invested to be restricted.

Investments
Investments are stated at fair value with unrealized gains and losses on investments being included in the Statements of Revenues, Expenses and Changes in Net Assets. Realized gains and losses are computed as the difference between the proceeds of the sale and the cost basis of investment sold. The calculation of realized gains and losses is independent of the calculation of net changes in the fair value of investments.

Title to investment securities is vested in the name of Securities and Exchange Commission ("SEC") registered brokerage firms representing the various investment managers of the University and the Foundation. Title of short-term investments, made from pooled cash, is vested in the name of the University or the Foundation.

Perpetual Trusts
The Foundation is the beneficiary of certain perpetual trusts held and administered by others. The present values of the estimated future cash receipts from the trusts are recognized as assets and contribution revenues at the dates the trusts are established. Distribution revenues from the trusts are recorded as endowment and investment income and the carrying value of the assets is adjusted for changes in the estimates of future receipts.

Split Interest Agreements
The Foundation's split interest agreements with donors consist of irrevocable pooled income funds, charitable remainder trusts and charitable gift annuities for which the Foundation serves as trustee. Assets held under the split interest agreements are included in investments. Contribution revenues are recognized at the date the split interest agreements are established after recording liabilities for the present value (5% discount rate) of the estimated future payments to be made to the donors and/or other beneficiaries. The liabilities are adjusted during the term of the split interest agreements for changes in the fair value of the assets, accretion of the discount, and other changes in the estimates of future benefits.

Contributions
The Foundation receives pledges and bequests of financial support from corporations, foundations, and individuals. Revenue is recognized when a pledge representing an unconditional promise to pay is received and all eligibility requirements, including time requirements, have been met. In

absence of such a promise, revenue is recognized when the gift is received. Endowment pledges do not meet eligibility requirements, as defined by GASB Statement No. 33, and are not recorded as assets until the related gift is received.

Capital Assets
Capital assets are recorded at cost, or if donated, at an appraised value. Depreciation of capital assets is provided for on a straight-line basis over the estimated useful lives (3 to 45 years) of the respective assets. Interest incurred on construction financing net of investment income on any unspent financing proceeds is capitalized as a cost of construction. The University does not capitalize works of art or historical treasures that are held for exhibition, education, research and public service. These collections are neither disposed of for financial gain nor encumbered. Accordingly, such collections are not recognized or capitalized for financial statement purposes.

The University evaluates the future service utility of their capital assets when events or changes in circumstances have occurred. A diminished service utility of the University's capital assets is reported as an impairment loss and netted against any insurance or appropriated recoveries. In 2005, the University early implemented GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries* as a framework to address the diminished service utility of particular capital assets impacted by the Manoa flood. The adoption of GASB Statement No. 42 did not have a significant impact on the University.

Advances from Sponsors
Amounts received from grant and contract sponsors which have not been earned under the terms of the agreement are deferred and reported as advances from sponsors in the consolidated statements of net assets.

Deferred Revenue
Deferred revenue includes amounts received in advance of an event such as student tuition and advance ticket sales related to future years.

Bonds Payable
The University defers recognition of bond refunding and issuance costs, and amortizes these costs as well as the premiums on bonds payable over the life of the bonds.

Net Assets
The University's net assets are classified into the following four net asset categories:

- Invested in capital assets, net of related debt: Capital assets, net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction or improvement of those assets.

- Restricted:

    - <u>Nonexpendable</u> – Net assets subject to externally imposed stipulations that they be maintained permanently by the University. Such assets include the University's permanent endowment funds.

- Expendable – Net assets whose use by the University is subject to externally-imposed stipulations that can be fulfilled by actions of the University pursuant to those stipulations or that expire by the passage of time.

- Unrestricted: Net assets that are not subject to externally imposed stipulations. Unrestricted net assets may be designated for specific purposes by action of management or the Board of Regents or may otherwise be limited by contractual agreements with outside parties. Substantially all unrestricted assets are designated for academic and research programs and initiatives, and capital asset programs.

Revenue Recognition
Student tuition and fees revenues are recognized in the period earned. Revenues for programs that cross fiscal years are prorated between the two fiscal years.

The University recognizes revenue associated with the direct costs of research and training grants and contracts with the Federal government as the related expenditures are incurred. Funds received in advance for these grants and contracts are recorded as an advance in the Statements of Net Assets until the related expenditures are incurred.

Scholarships and Fellowships
Scholarships and fellowships, including tuition and fee waivers applied to student accounts are shown as a reduction to student tuition and student housing revenues. Stipend and other payments made directly to students are reflected as scholarships and fellowships expense.

Operating and Nonoperating Activities
The University's policy for defining operating activities as reported on the Statements of Revenues, Expenses, and Changes in Net Assets are those that generally result from exchange transactions such as payments received for providing services and payment made for services and goods received. Certain significant revenue streams relied upon for operations are recorded as nonoperating revenues, as defined by GASB Statement No. 35, including state appropriations, gifts and investment income.

Management's Estimates
The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions affecting the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates. These estimates, among others, include allowances for uncollectible accounts and workers' compensation liabilities.

The University uses third party analyses to estimate its workers' compensation liability. Changes in the liability are the result of claims payments made during the fiscal year, new claims filed and changes in the estimates of existing claims. Anticipated payments by the third party for the next fiscal year are considered current and payments thereafter are considered noncurrent. The liability at June 30, 2005 and 2004 represents the University's best estimate of workers' compensation liabilities based on available information.

Allowance for doubtful accounts is a valuation account used to estimate the portion of accounts receivable that is considered uncollectible. Estimates for uncollectible accounts are based on the age of the receivable and likelihood of payment.

Reclassifications
The University invests a portion of its excess operating cash balances in student loan auction rate securities ("auction rate securities"). Prior to 2005, the University reported auction rate securities as cash equivalents based on the University's ability to sell these securities every 7 to 28 days as part of an auction process. During 2005, the University determined that auction rate securities should be reported as operating investments instead of cash equivalents since the auction rate securities are collateralized by student loans with original maturities greater than 90 days. In order to conform the 2004 consolidated financial statements to the 2005 presentation, $42.9 million in auction rate securities were reclassified from cash and cash equivalents to operating investments in the consolidated statement of net assets at June 30, 2004. In addition, the 2004 consolidated statement of cash flows was modified to reflect $124.8 million in purchases and $102.4 million in sales of auction rate securities during 2004. The reclassification of auction rate securities to operating investments had no effect on current, non-current or net assets at June 30, 2004, the increase in net assets during the year ended June 30, 2004, the classification of debt balances at June 30, 2004, or net cash used in operating activities during the year ended June 30, 2004, as previously reported.

2. Cash and Investments

At June 30, 2005 and 2004, information relating to the insurance and collateral of funds deposited with the State Treasury is not available since such information is determined on a statewide basis and not for individual departments. Cash deposits with the State Treasury are either federally insured or collateralized with obligations of the State or the United States. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

The carrying amounts of cash and time certificates of deposit not on deposit in the State Treasury as of June 30, 2005 and 2004 were $65,073,516 and $48,500,053, with corresponding bank balances of $80,904,023 and $72,949,688, respectively. The portion of such bank balances covered by Federal deposit insurance or by collateral held by the State Director of Finance in the name of the University totaled $80,367,537 as of June 30, 2005 and $72,676,748 as of June 30, 2004. At June 30, 2005 and 2004, the remaining bank balances of $536,486 and $272,940, respectively, as managed by the Foundation, were uncollateralized. Additional cash equivalent balances of $11,357,020 as of June 30, 2005 and $8,896,930 as of June 30, 2004 represent deposits with investment brokers covered by the Securities Investor Protection Corporation and additional insurance provided by the investment brokers.

The University's investment strategy incorporates certain financial instruments, which involve, to varying degrees, elements of market risk and credit risk in excess of amounts recorded in the financial statements. Market risk is the potential for changes in the value of financial instruments due to market changes, including interest and foreign exchange rate movements and fluctuations embodied in forward, futures, commodity or security prices. Market risk is directly impacted by the volatility and liquidity of the markets in which the related underlying assets are traded. Credit risk is the possibility that a loss may occur due to the failure of a counterparty to perform according to the terms of the contract. The University's risk of loss in the event of counterparty default is typically limited to the amounts recognized in the Statements of Net Assets and are not represented by the contract or notional amounts of the instruments.

Endowment funds are combined in investment pools with each individual account subscribing to or disposing of shares on the basis of the market value per share.

Cost of securities sold is determined using the first-in first-out method.

As a result of market declines, the fair market value of certain donor-restricted endowments was less than the historical cost value of such funds by $306,425 and $269,725 at June 30, 2005 and 2004, respectively. These unrealized losses have been recorded as reductions in unrestricted net assets. Future market gains will be used to restore this deficiency in unrestricted net assets before any net appreciation above the historical cost value of such funds increases restricted expendable net assets.

Endowment funds are received from benefactors who, by the terms of their conveying instruments, have stipulated that the principal of their gifts may never be expended, and use of the income is generally restricted.

Quasi-endowment funds are funds that have been transferred to the endowment funds by the Board of Regents. Use of the income is either restricted by the donor or unrestricted and designated by the Board of Regents.

State law allows spending of net appreciation, realized and unrealized in the fair value of the assets, of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by Hawai'i Revised Statute §517D-4. The University distributes its endowment fund income in accordance with its Board approved spending rate policy, which is consistent with state law.

The University's and Foundation's endowment spending policy provided for an annual distribution of 3% to 6% of the preceding year's endowment fair value in fiscal year 2004. Effective fiscal year 2005, the University adopted a new spending rate policy that provides for an annual distribution ranging from 3% to 5% of the five-year moving average of the endowment fair value.

Investment management fees paid by the University during fiscal years 2005 and 2004 amounted to approximately $725,000 and $776,000, respectively.

At June 30, 2005 and 2004, the University's investments were comprised of the following:

	2005		2004	
	Fair Value	Cost	Fair Value	Cost
Fixed income securities	$ 146,380,633	$ 162,875,224	$ 202,413,983	$ 219,283,028
Equity securities	101,845,539	87,443,131	101,497,357	87,301,816
Mutual funds	55,097,171	36,961,089	47,828,821	33,214,899
Time certificates of deposit	51,953,115	51,953,115	34,443,338	34,443,338
Other investments	17,189,708	17,147,954	44,156,453	44,114,699
Total investments	372,466,166	356,380,513	430,339,952	418,357,780
Less current portion	131,805,287	132,762,443	141,987,778	142,452,616
Total noncurrent investments	$ 240,660,879	$ 223,618,070	$ 288,352,174	$ 275,905,164

Changes in the endowment and other investments for the year ended June 30, 2005 are as follows:

	Fair Value	Cost Basis	Unrealized Net Gain/(Loss)	Realized Net Gain/(Loss)
University Endowment Pool				
End of year	$ 48,554,569	$ 45,261,442	$ 3,293,127	
Beginning of year	46,276,676	42,418,711	3,857,965	
Net increase (decrease)	2,277,893	2,842,731	(564,838)	$ 2,053,968
Foundation Endowment Pool				
End of year	127,191,678	112,474,557	14,717,121	
Beginning of year	116,482,002	105,682,773	10,799,229	
Net increase	10,709,676	6,791,784	3,917,892	2,705,096
Associated Students of the University of Hawai'i				
End of year	6,039,266	5,758,988	280,278	
Beginning of year	5,400,839	5,101,511	299,328	
Net increase (decrease)	638,427	657,477	(19,050)	231,641
School of Medicine				
End of year	29,533,702	30,667,299	(1,133,597)	
Beginning of year	94,672,249	97,056,914	(2,384,665)	
Net increase (decrease)	(65,138,547)	(66,389,615)	1,251,068	(2,518,666)
Operating investments				
End of year	131,805,287	132,762,443	(957,156)	
Beginning of year	141,987,778	142,452,616	(464,838)	
Net increase (decrease)	(10,182,491)	(9,690,173)	(492,318)	82,842
Other				
End of year	29,341,664	29,455,784	(114,120)	
Beginning of year	25,520,408	25,645,255	(124,847)	
Net increase	3,821,256	3,810,529	10,727	194,434
Total investments				
End of year	372,466,166	356,380,513	16,085,653	
Beginning of year	430,339,952	418,357,780	11,982,172	-
Net increase (decrease)	$ (57,873,786)	$ (61,977,267)	$ 4,103,481	$ 2,749,315

Summary of investment income	**2005**	**2004**
Change in unrealized net gain	$ 4,103,481	$ 8,860,541
Realized net gain	2,749,315	5,621,932
	6,852,796	14,482,473
Interest in perpetual trusts	174,058	399,306
Split interest agreements	97,515	(999,023)
Amounts held for others	(48,037)	(212,556)
Investment income used to finance construction costs	(1,427,179)	(1,012,366)
Net interest and dividend income	13,526,940	13,992,115
Net investment income	$ 19,176,093	$ 26,649,949

Changes in the endowment and other investments for the year ended June 30, 2004 are as follows:

	Fair Value	Cost Basis	Unrealized Net Gain/(Loss)	Realized Net Gain/(Loss)
University Endowment Pool				
End of year	$ 46,276,676	$ 42,418,711	$ 3,857,965	
Beginning of year	39,486,026	38,306,809	1,179,217	
Net increase	6,790,650	4,111,902	2,678,748	$ 2,459,256
Foundation Endowment Pool				
End of year	116,482,002	105,682,773	10,799,229	
Beginning of year	93,623,281	91,957,138	1,666,143	
Net increase	22,858,721	13,725,635	9,133,086	6,430,922
Associated Students of the University of Hawai'i				
End of year	5,400,839	5,101,511	299,328	
Beginning of year	5,270,709	5,316,082	(45,373)	
Net increase (decrease)	130,130	(214,571)	344,701	353,632
School of Medicine				
End of year	94,672,249	97,056,914	(2,384,665)	
Beginning of year	127,548,292	128,511,725	(963,433)	
Net decrease	(32,876,043)	(31,454,811)	(1,421,232)	(3,532,990)
Operating investments				
End of year	141,987,778	142,452,616	(464,838)	
Beginning of year	113,967,604	112,733,608	1,233,996	
Net increase (decrease)	28,020,174	29,719,008	(1,698,834)	(54,148)
Other				
End of year	25,520,408	25,645,255	(124,847)	
Beginning of year	27,355,186	27,304,105	51,081	
Net decrease	(1,834,778)	(1,658,850)	(175,928)	(34,740)
Total investments				
End of year	430,339,952	418,357,780	11,982,172	
Beginning of year	407,251,098	404,129,467	3,121,631	-
Net increase	$ 23,088,854	$ 14,228,313	$ 8,860,541	$ 5,621,932

The Board of Regents is responsible for the establishment of policies over and monitoring of operating investments and endowments held by the University. Investments authorized by the Board of Regents include equity investments, bond investments, certificates of deposit, money market funds, U.S. Government, its Agencies, or its Instrumentalities securities, securities guaranteed by or collateralized by securities guaranteed by the U.S. Government, its Agencies or its Instrumentalities and other types of investments.

The Board of Directors of the Foundation is responsible for the establishment of policies over and monitoring of investments and endowments held by the Foundation.

Investment Risk Factors

There are many factors that affect the value of investments. Some, such as custodial credit 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.

Credit Risk

Credit risk for fixed income securities is the risk that the issuer will not fulfill its obligations. Nationally recognized statistical rating organizations, such as Moody's and Standard and Poor's, assign credit ratings to security issuers and issues that indicate a measure of potential credit risk to investors. To manage credit risk, the University specifies that all nonconvertible bonds should have at least a "BBB" rating or higher and be readily marketable. In addition, no more that 15% of the fixed income investments may be graded with an S&P quality rating below "A".

The composition of fixed income securities at June 30, 2005 and 2004, along with credit quality ratings is summarized below:

	FY2005 Fair Value	U.S. Govt-Exempt	Credit Quality Rating AAA	AA	A	BBB
U.S. treasury	$ 23,017,684	$ 23,017,684	$ -	$ -	$ -	$ -
U.S. government agencies	113,562,618	140,367	113,422,251	-	-	-
Corporate bonds	9,653,424	-	1,822,834	3,402,118	4,050,392	378,080
Other	146,907	-	-	146,907	-	-
Total fixed income securities	$ 146,380,633	$ 23,158,051	$ 115,245,085	$ 3,549,025	$ 4,050,392	$ 378,080

	FY2004 Fair Value	U.S. Govt-Exempt	Credit Quality Rating AAA	AA	A	BBB
U.S. treasury	$ 21,731,455	$ 21,731,455	$ -	$ -	$ -	$ -
U.S. government agencies	170,063,925	290,250	169,773,675	-	-	-
Corporate bonds	10,472,249	-	1,418,782	2,615,858	2,884,374	3,553,235
Other	146,354	-	-	146,354	-	-
Total fixed income securities	$ 202,413,983	$ 22,021,705	$ 171,192,457	$ 2,762,212	$ 2,884,374	$ 3,553,235

Interest Rate Risk

Interest rate risk is the risk that the value of fixed income securities will decline because of changing 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.

At June 30, 2005 and 2004, the composition of the University's fixed income investments and maturities are summarized below:

	2005 Fair Value	Investment Maturities (in Years) less than 1	1 to 5	6 to 10	More than 10
U.S. treasury	$ 23,017,684	$ 12,381,476	$ 8,113,228	$ 2,334,400	$ 188,580
U.S. government agencies	113,562,618	42,311,784	64,302,707	5,432,393	1,515,734
Corporate bonds	9,653,424	762,186	6,434,268	2,171,850	285,120
Other	146,907	-	146,907	-	-
Total fixed income securities	$ 146,380,633	$ 55,455,446	$ 78,997,110	$ 9,938,643	$ 1,989,434

	2004 Fair Value	Investment Maturities (in Years) less than 1	1 to 5	6 to 10	More than 10
U.S. treasury	$ 21,731,455	$ 4,418,522	$ 16,218,488	$ 1,052,952	$ 41,493
U.S. government agencies	170,063,925	75,171,565	89,781,840	4,137,779	972,741
Corporate bonds	10,472,249	841,062	6,453,154	3,178,033	-
Other	146,354	-	146,354	-	-
Total fixed income securities	$ 202,413,983	$ 80,431,149	$ 112,599,836	$ 8,368,764	$ 1,014,234

Concentration of Credit Risk

Concentration of credit risk is the risk associated with a lack of diversification, such as having substantial investments in a few individual issuers, thereby exposing the organization to greater risks resulting from adverse economic, political, regulatory, geographic or credit development. The University limits its risk of concentration of assets by limiting individual bond positions other than obligations of the U.S. government to not more than 5% of the total fixed income portion of the portfolio. Individual equities are limited to not more than 5% of the total market value of the stock portfolio. In addition, investment in any one stock is not to exceed 5% of the corporation's outstanding common stock.

Foreign Currency Risk

Foreign currency risk is the risk that investments denominated in foreign currencies may lose value due to adverse fluctuations in the value of the U.S. dollar relative to foreign currencies. The University's investment policy permits investment in publicly traded foreign securities.

At June 30, 2005 and 2004, the University's exposure to foreign currency risk expressed in U.S. dollars is as follows:

	2005	2004
Equity securities		
British pound	$ 999,489	$ 222,052
Euro	-	46,577
Mutual fund		
British pound	9,601,153	8,102,741
Total exposure to foreign currency risk	$ 10,600,642	$ 8,371,370